WORLD DEBT SITUATION

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY

OF THE

COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

SEPTEMBER 27, 1982

Printed for the use of the Committee on Foreign Relations

U.S. GOVERNMENT PRINTING OFFICE

11-299 O WASHINGTON: 1983

S381-14

COMMITTEE ON FOREIGN RELATIONS

CHARLES H. PERCY, Illinois, *Chairman*

HOWARD H. BAKER, JR., Tennessee	CLAIBORNE PELL, Rhode Island
JESSE HELMS, North Carolina	JOSEPH R. BIDEN, JR., Delaware
S. I. HAYAKAWA, California	JOHN GLENN, Ohio
RICHARD G. LUGAR, Indiana	PAUL S. SARBANES, Maryland
CHARLES McC. MATHIAS, JR., Maryland	EDWARD ZORINSKY, Nebraska
NANCY L. KASSEBAUM, Kansas	PAUL E. TSONGAS, Massachusetts
RUDY BOSCHWITZ, Minnesota	ALAN CRANSTON, California
LARRY PRESSLER, South Dakota	CHRISTOPHER J. DODD, Connecticut

EDWARD G. SANDERS, *Staff Director*
GERYLD B. CHRISTIANSON, *Minority Staff Director*

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY

CHARLES McC. MATHIAS, JR., Maryland, *Chairman*

CHARLES H. PERCY, Illinois	CHRISTOPHER J. DODD, Connecticut
RICHARD G. LUGAR, Indiana	JOSEPH R. BIDEN, JR., Delaware
NANCY L. KASSEBAUM, Kansas	PAUL S. SARBANES, Maryland

CONTENTS

	Page
Hearing day:	
September 27, 1982	1
Statement of—	
Bergsten, Hon. C. Fred, director, Institute for International Economics, Washington, D.C.	2
Clark, George J., executive vice president, Citicorp/Citibank, New York, N.Y.	8
Garten, Jeffrey E., vice president, Lehman Brothers Kuhn Leob, Inc., New York, N.Y.	13
McNamar, Hon. Richard T., Deputy Securetary of the Treasury	31
Insertions for the record:	
Mr. Clark's biographical sketch	8
Prepared statement of George J. Clark	12
Prepared statement of Jeffrey E. Garten	15
Treasury forecast of the aggregate account deficit of non-OPEC developing countries	47
Appendix:	
Prepared statement of John A. Mathieson, SRI International, Arlington, Va	53

WORLD DEBT SITUATION

MONDAY, SEPTEMBER 27, 1982

UNITED STATES SENATE,
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 4221, Dirksen Senate Office Building, Hon. Charles McC. Mathias, Jr. (chairman of the subcommittee) presiding.

Present: Senator Mathias.

Senator MATHIAS. The committee will come to order. We are meeting today to look at the serious global problem of international debt. Perhaps it would be more accurate to say national debt to international creditors, with particular emphasis on the capability of international institutions that exist today, to cope with the kind of problems that do exist and that may arise foreseeably in the near future.

This is a subject of critical importance. Very often today, national security is equated with statistics such as missile throw-weight or conventional force ratios, but of course, thoughtful citizens recognize that military strength is only one component of national security, and that economic stability is a basic foundation of national strength and of international stability.

In August of this year, the Government of Mexico advised the Government of the United States that its foreign currency reserves were severely curtailed. For a country with an external debt of $80 billion, this obviously had a significant impact on the world financial community. There was a rescue operation mounted which overcame the immediate difficulty, and I would emphasize that it was the immediate difficulty, not the solving of the total problem.

But the situation in Mexico is not, in any sense, unique. Other countries have acquired very substantial external debt. This was done at a time of high inflation and low real interest rates, and now we have the reverse situation, which is creating an enormous difficulty in some of the countries most heavily indebted.

Fears have been raised in this country and elsewhere that the commercial banks that participated in successfully recycling OPEC's surpluses in the 1970's are now overexposed in their lending to the developing countries.

Others are concerned that we will lose sight of the fact that some of the developing countries have significant growth potential. These countries may be in trouble in cash terms today, but have relatively optimistic futures.

So our task this morning is to make an interim assessment of the situation. Later, the committee will be actively involved in decisions

with respect to increases in an international monetary fund quota and in United States participation in IDA [International Development Association] VII.

These are decisions that must inevitably flow from a sound understanding of the global economic trends and needs. I would question—certainly speaking for myself and not for the others who gather around this bench—I would question whether I have an adequate understanding of these problems.

So this morning, I hope we can assess the financial economic prospects of the major developing debtor nations. We can study the factors which would make these prospects improve or deteriorate, and examine the prudent roles that the multilateral financial institutions and the private lending institutions should be playing today and in the near future.

This is a large order, but we have distinguished experts here, and we look forward to a productive morning. The first panel to testify will include Mr. C. Fred Bergsten, director of the Institute for International Economics; Mr. Jeffrey E. Garten of Lehman Brothers Kuhn Loeb, Inc., of New York; and Mr. George J. Clark, executive vice president of Citicorp.

Gentlemen, have you decided in what order you wish to testify? We can do it alphabetically or as you are seated at the table.

Mr. CLARK. Mr. Bergsten is a statesman in this field. Why don't we ask him to begin?

Senator MATHIAS. All right, we will start with Mr. Bergsten, who I might add has had lots of experience in testifying at this table.

STATEMENT OF HON. C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. BERGSTEN. Thank you very much, Mr. Chairman. It is a pleasure to be back to comment on what is an obviously extremely serious problem; that of the existing debt situation in the world economy.

It is extremely serious in two senses. One sense is, as you suggested in your own opening remarks, that any resolution of the current international debt problem is likely to further depress the world economy itself. I will come back to that remark later in my comments, but I think it is extremely important to keep in mind that any way one can find to get through the immediate problem is going to have longer term negative repercussions on the world economy as a whole, which in my view adds to the case for some basic changes in economic policy around the world which I will return to in a moment.

But the second and more immediate concern that most people would now have is whether the debt situation raises the risk of financial disruption either within the U.S. banking system or elsewhere around the world, particularly when these international problems are taken in conjunction with domestic loan problems, as have been emerging frequently over the last several months.

Seen from the standpoint of the banking system or the stability of the financial network, one, of course, has to see together the international problems, be they centered on Mexico, Argentina, or somewhere else, along with the domestic problems, be they centered on Penn Square, International Harvester, or Drysdale Securities or any other domestic problems that have arisen over the past several months.

If one looks at the international issue in aggregate form, there are a number of different ways to characterize the problem. Different people use different ratios and different concepts. I would mention only two this morning which I think depict a quite serious situation. In doing so, I would add to the debt problem that we are talking about short-term debt that is owed by the foreign countries to institutions in the United States and elsewhere.

I flag that point because in most of the analyses one treats only long- and medium-term debt, basically because short-term debt numbers are not always available and also because there is an assumption that short-term debt is rather readily rolled over. In most cases, it is readily rolled over, but in particular situations such as the present, the possibility of its not being rolled over is, in fact, part of the problem. Therefore, I think it needs to be considered in looking at the problem.

When you include short-term debt you find a couple of rather alarming facts. One is that now, almost 50 percent of the export earnings of the developing countries have to be used to finance their existing debt, including their short-term debt; that is, interest and principal. But roughly half of all of their export earnings have to go for debt finance.

Second, almost all of the current account deficits of the developing countries wind up now being used to service their external debt. In other words, all or virtually all of the new lending that is going into the developing countries taken as a group is, in some net sense, used to finance their interest payments and amortization of their current debt. So one does have a situation where the debt level and servicing requirements that face the developing countries do, in fact, stack up very, very formidably compared with either their export earnings or their overall net financing requirements, therefore suggesting at the aggregate level quite a substantial problem.

However, I would quickly add that aggregates do not create economic problems; it is individual countries which may, or individual borrowers at the national level. And therefore, one has to look beyond the aggregates to the specific country situations that might cause problems.

At the moment, the focus of attention is on three particular countries, Mexico, Argentina, and Brazil. I will not go into a long exigesis on each of those countries, though one may want to go into that later on.

I think it is fair to say that in the Mexican case, the resources are certainly available for the country to service its debt over the longer run. The issue is whether, in the immediate future, Mexico will be able and willing to deal with its liquidity crisis through putting together an effective economic stabilization program that will both deal with its immediate economc problems and restore confidence on the part of foreign lenders, that it will be able to come out of its difficulties and, therefore, continue to borrow to finance itself through this short-term problem.

In the Argentine case, there seems to be a major effort underway on the part of the Government to put together a stabilization program and perhaps work out with the International Monetary Fund [IMF] an arrangement that would provide a basis for dealing with the problem on a constructive basis.

Brazil, I think, somewhat to the contrary, has already, over the last 2 years, put into place quite a vigorous economic stabilization program. In December 1980 Brazil adopted very stringent policy measures. Last year it ran a negative growth rate of 4 percent, the first negative growth rate, incidentally, in Brazil in over 50 years, therefore indicating its willingness and its ability to bring its economy under check in order to help deal with its external problems. There are continued difficulties there, but I think in the Brazilian case already a major effort has been put into place.

Now, in asking whether any of these countries' situations are going to cause major problems, one has to ask what is the system for dealing with debt problems under our current institutional arrangements. I think one can characterize the response mechanism as a three-part system. The first part is that the debtor countries themselves have the responsibility to come up with stabilization programs that will both deal immediately with their problems by improving their external balance and their internal economies, and encourage foreign lenders, both official and private, to have a restoration of confidence in their position.

Second, and critically important to the whole system, the International Monetary Fund in most cases needs to be involved to both help the country work out its program, provide some of the necessary financial resources from abroad and perhaps most importantly to bless the economic adjustment program that is being adopted which, in turn, is a very important source of confidence to private lenders around the world.

Third, then, the private banks who, based on the stabilization program and the blessing of the IMF, have to fulfill their role at a minimum by not cutting and running away from the situation which they in part have helped to create, have to at a minimum maintain their current levels of lending and in most cases, add at least incrementally to the margins that they are willing to put into the country to help finance its ongoing external deficits.

In some cases, when a rescheduling is necessary the private banks, of course, then have to play their role as well to reschedule the debt along the lines that have been worked out in dozens of cases over the last few years.

If all three of these steps work, then I think any individual debt problem or even series of debt problems can, in fact, be handled. The $64 billion question, of course, is whether in fact there will be in each case.

The first question, will the debtors undertake effective programs, has already been addressed briefly. In the Brazilian case I think already for almost 2 years they have had a major stabilization program in place. One or two more steps may be needed, but they basically have.

I would digress a moment to say that I think Brazil is largely being sideswiped by the problems that are now existing in other countries. In this case, notably, Mexico and Argentina.

Back in the spring you will recall that Hungary, whose own economic situation, while it had problems, was by no means critical, faced a temporary period where its access to foreign capital dried up. The main reason was it was sideswiped by the psychological impact of what was going on at that time in Poland and Romania.

I think something of the same is now happening in the Brazilian case where there has, in the recent past, been a diminution of lending to Brazil in large part, I think, because of the psychological spinoffs from the more serious, in a real sense, Mexican and Argentine, cases. So with Brazil I would say it is mainly a spinoff problem, and also, there is in place a stabilization program which may need some beefing up in a couple of quarters but which on the whole is in place.

The big issues are Mexico and Argentina.

Senator MATHIAS. You make international high finance sound like a small town banking problem where if a member of a family gets into trouble, why, every other member of the family is likely to find trouble with credit.

Mr. BERGSTEN. I think there is something to that, Mr. Chairman.

Senator MATHIAS. It reduces these problems of huge magnitude to a very human dimension.

Mr. BERGSTEN. I think that is probably correct. The psychological elements of all of these problems are immensely important, and there is the same kind of spinoff at these levels of billions of dollars as there are at thousands of dollars in the local community. I think that is quite right.

As I said before, in the Mexican and Argentine cases the issue is whether they will be able to adopt stabilization programs. I think one can take great encouragement from the interview in this morning's Wall Street Journal with Carlos Tello, the new head of the Central Bank in Mexico, indicating his hope and expectation that Mexico would, in fact, work out a stabilization program with the IMF. That is obviously essential and needs to be done as soon as possible. I think that was quite an encouraging statement to that effect.

But the big question mark I think in the whole process remains will the countries who are most imminently now in difficulty—and I would highlight Mexico and Argentina, but also remember Poland which remains a basically unresolved issue—whether those countries will put into place the kind of stabilization programs that are necessary to permit a restoration of confidence and lending to continue.

The second piece in the whole program is the role of the International Monetary Fund. The IMF's resources can play an important part in helping tide countries over these problems, and even more important, the IMF's good housekeeping seal of approval is an important indicator of stability of a country's program, and an indicator that private lending is likely to resume. The IMF is obviously geared to try its best in all of these situations.

But I think a serious problem in the current situation is a potential shortfall of IMF resources to deal with the problem. Just a month ago, my institute published a study on the role of IMF in lending programs to developing countries and derived some estimates of the amounts of money that the Fund would need to carry out its responsibilities over the next few years.

We concluded that there was a serious question whether the IMF had useable resources sufficient to deal with the array of debtor country problems that now may be coming onto its plate. To put it in simple terms, if Mexico and Argentina were to come in today, the Fund might well have enough money to scrape by, but if Brazil or

11-299 O - 83 - 2

any other major debtor countries were to come in in addition, it is not clear that the IMF would have the financial resources to commit enough to help induce those countries to adopt effective stabilization programs and restore the needed confidence.

It therefore seems urgent to assure adequate resources at the IMF so that it can play a central role in this process. I think, in fact, a major opportunity was missed, perhaps tragically missed, at the Toronto annual meeting of the IMF earlier this month when only because of opposition by the United States was there a failure to reach agreement on a sharp expansion of IMF quotas. I think the rest of the countries there assembled would have been prepared to announce at that point an expansion of IMF quotas from the current level of roughly 60 billion SDR to 100 billion SDR for the next quota period.

That quota period begins in 1985, but announcing it now would already add confidence to the system's view that the IMF will be able to play its role in the process. And I think it was most unfortunate that agreement was not reached at that point, both for substantive reasons and for reasons of adding to confidence.

However, as I note, the IMF quota increase will only go into effect in 1985, 3 years away. So it is clear in addition that we need some kind of bridging mechanism to be sure that the IMF between now and then has the resources available to do its job in case a number of these debtor countries come in, as they probably should and most likely will.

One model for augmenting IMF resources would be to carry out the same kind of facility now that was done in 1978 when this committee and others in the Congress authorized U.S. participation in the Witteveen Facility which provided at that time an additional $10 billion worth of credit lines from major surplus countries and industrial countries to the IMF, so that it in turn would have the resources to carry out its program.

At this time, I think the resources that need to be available to the IMF are more on the order of $20 to $25 billion, but the major countries should promptly put together a program of that type so that the IMF will assuredly have the resources it needs to carry out its role in the process.

I would add, beyond the IMF, Mr. Chairman, one related point. Whatever outcome we have from the current debt situation, it is clear that the private banks will be somewhat more reluctant to extend their exposure into the developing countries than they have been in the past. That means at least two things. It means that the developing countries will have to redouble their efforts to reduce their external deficits, which now are approaching $90 to $100 billion a year. But one cannot really imagine the developing countries reducing their deficits so fast as to obviate the need still for substantial amounts of external finance.

And if the private banks are going to cut back substantially, which I think is an inevitable result of all this, it does imply the need for a sharp increase in public finance going into the developing countries.

Now, part of that can be done through the IMF, but I think another important part is going to have to be done through the World Bank family. And therefore, as part of a solution to this overall problem, one

is going to have to contemplate significant additions to lending through the World Bank.

You more than most know that that does not require budgetary resources, or at most only a small margin of budgetary resources, but it does require a policy decision that the World Bank itself should borrow additional sums beyond the large sums it is already borrowing in the private capital market to pick up a bigger share of the intermediation role.

You mentioned at the outset IDA VII, which of course does require budgetary resources and channels concessional assistance to the poorest developing countries. Although they do not borrow very heavily from private banks, they, too, will be hit by this whole process, so there will be a need for increased lending of that type, as well when one looks to an overall solution of this problem.

So, in addition to increased IMF quotas, one has to put together some kind of bridging facility, perhaps along the lines of the earlier Witteveen Facility, to supplement the resources of the IMF. In addition, one finally has to imagine significant increases in World Bank and, to some extent, IDA lending to permit the whole process to be put together.

One would have to note in conclusion that some of these changes would require changes on the part of U.S. policy, as it has currently been enunciated. Certainly in terms of the level of IMF quotas, perhaps in terms of putting together a supplementary fund for the IMF, certainly in terms of a greater role for the World Bank. But I think all of those changes are going to have to be made, again, for two reasons.

One is to deal with the immediate problem of financial stringency which we face, and second—and I will close on this point because I think it is perhaps in the medium and longer-run sense the most important—because of the effects on the world economy.

In some sense, the debt problem that we face today both at home and abroad is one more manifestation of the fact that both the world and U.S. economies are dead in the water. We are now experiencing our third year of flat or very low economic growth, and I am afraid the outlook is for more of the same.

As that continues, the underlying economic structure is going to become further jeopardized and weakened in terms of the financial system and all of these problems that we are talking about, including specifically the problems of the developing countries. If we are not to contemplate continued sluggishness, indeed, stagnation of the world economy, a comprehensive program is going to have to be put together including some changes in domestic macroeconomic policy which are not the subject of today's hearings, but also, some changes on the purely international side in which I would accord a central role to the IMF and World Bank lending. Thank you very much.

Senator MATHIAS. Thank you, Mr. Bergsten.

I think it would probably be more useful to reserve my questions until each member of the panel has spoken. Then we can have a general conversation.

Mr. Clark, would you like to proceed?

[Mr. Clark's biographical sketch follows:]

BIOGRAPHICAL SKETCH OF GEORGE J. CLARK

George J. Clark, an Executive Vice President of Citibank, N.A., represents Citicorp in the international area and supervises the senior corporate officers worldwide who are responsible for administering corporate policy and controls as well as long-term business development overseas. Mr. Clark also supervises the establishment of country risk-exposure lending limits.

Mr. Clark joined Citibank in 1964 as an assistant vice president handling government and central bank relationships in the overseas division and was appointed a vice president the following year. He later supervised bank operations in the Western Caribbean and South America and was elected a senior vice president in 1969. He assumed responsibilities for the bank's operations in Canada, the Caribbean, Central and South America in 1973 and was placed in charge of operations in Asia and Africa in 1976. He assumed his present position in July 1981.

Prior to joining Citibank, Mr. Clark had been chief of the Caribbean Division of the International Monetary Fund. Before joining the IMF in 1956, he was deputy director of the Foreign Trade Administration of the Greek government's Economics Ministry in Athens.

After World War II service as a U.S. Marine Corps officer in the Pacific, Mr. Clark was graduated from Yale University in 1947. He received a master's degree in business administration from Harvard in 1949 and a master's degree in public administration in 1956.

Born in Massachusetts on January 18, 1925, Mr. Clark and his wife, the former La Jean Avery, have three children and live in New Cannan, Conn.

STATEMENT OF GEORGE J. CLARK, EXECUTIVE VICE PRESIDENT, CITICORP/CITIBANK, NEW YORK, N.Y.

Mr. CLARK. Thank you, Mr. Chairman.

Some of the recent developments, particularly as Fred has mentioned with regard to Argentina and Mexico, have raised the questions of whether there may be excessive commercial debt outstanding to the developing countries. Thanks to you, Mr. Chairman, as a commercial banker I am very pleased to have a chance to express our point of view on this obviously very important subject.

A little bit of statistical background is in order. The whole process started in 1973 with the OPEC shock, and as a result of what happened thereafter from 1973 to 1981 the long-term and medium-term debt of the 109 non-OPEC developing countries increased from $97 billion to $437 billion at the end of 1981; $437 billion, a very large amount of money.

By 1981, the total of these borrowings was adding approximately $40 billion a year to these outstandings. That is to say, the commercial bank financing of the adjustment process was adding net new about $40 billion a year, also a very large number, to these amounts. And it is not surprising, in view of the size of the funding involved, that this would be a topic of widespread interest.

I should follow up by saying that the growth of this indebtedness on the one side has been nearly paralleled by the growth in foreign exchange earnings of the developing countries since 1973. Consequently, the ability of the developing countries to earn sufficient foreign exchange to service this indebtedness has gone up nearly as fast as the debt itself, something which is very often not mentioned in the presentations on this subject.

However, we all have to agree that in spite of the increased ability of the developing countries over the years to earn foreign exchange, the

total size of the debt is now large and it certainly raises the legitimate question of whether a liquidity problem might arise.

Since a substantial amount of ths indebtedness matures each year, the developing countries are faced with the need for additional borrowings regularly to be in a position to meet these maturing obligations and also to finance any continuing deficits in their current accounts, which continue large.

I believe that a part of the apprehension about this subject results from the fact that it is often poorly presented. For example, one of the questions you run into continually when you get into this kind of discussion is the following: The question is posed, will this debt ever be repaid? Do the developing countries have the capabilities of repaying this indebtedness.

Senator MATHIAS. If I could interrupt you, Mr. Clark. I think when people are getting news that they do not want to hear, their resistance to understanding is much higher than otherwise, no matter how well presented the information may be.

Mr. CLARK. I am sorry, Mr. Chairman. This is something that is perceived to be already common knowledge; is that what you mean?

Senator MATHIAS. No. I think people do not want to hear the bad news and therefore, no matter how you organize it and present it, their resistance to understanding is higher than it would be if you were giving them good news. But that is just an observation. Please do not let it interrupt your train of thought.

Mr. CLARK. Can I in any way adapt my sails to the wind? [Laughter.]

Senator MATHIAS. No, no. Please continue.

Mr. CLARK. The point that I did want to make here, though, I think is a critical one. In Government lending, which is often distinct from corporate lending, we do not really anticipate that governments in general reduce the level of their total debt.

This is something that we take for granted with respect to the U.S. Government, for example. Our debt ceilings go up regularly. The Treasury refinanced $11 billion of debt this month, and that was hardly a noteworthy item.

But when the developing countries have to go out into the capital markets to finance the maturities of their old debt with new debt, this is somehow perceived as something that suggests that they are not creditworthy. We would like to remind our audience that rolling over of government debt is a normal affair at the Federal, State, or international levels.

What is important in this process is that the governments abroad continue to carry out good financial policies and pay their obligations on maturity, so that their creditworthiness is sustained, so that new debt can be issued. To assure that good financial policies are carried out, we often rely on programs with the International Monetary Fund.

I thought some perspective might be useful in this regard with respect to our own municipal and State government problems. Four or 5 years ago, it was very widely held here in the United States that our State and municipal governments had deficits which were too large and were not financable and that those governments were losing their creditworthiness.

What happened there was that they responded to the problem they had. They took the appropriate fiscal measures and they are currently by and large eminently creditworthy today. And, in fact, we have even forgotten about the problems they had 4 or 5 years ago.

Many of the foreign governments have gone through similar phases in the recent past. Peru, Brazil, and Turkey were countries that were considered weak credits and today are considered greatly improved credits. So we have the situation of the revolving nature of public sector debt, and when one remembers that debt does roll, the ability of servicing it really is reduced to the interest payments associated thereto.

And if the debt is growing, as I think it should and as Fred indicated he thought it should, you have capital inflows to service the interest being paid. So that you really have a very substantial reduction, I believe, in the perceived and actual burden of servicing this indebtedness.

Now, much of the current concern, I believe, reflects the fear that the banks may overreact to the current situations in Mexico and Argentina. If they did so, it would be possible to create a liquidity problem as governments find that they are being called upon to pay off much of their foreign borrowings in a short period of time without the issuance of sufficient new loans, as I mentioned earlier. To some extent this is what happened last year in Yugoslavia and Hungary as a result of the Polish situation.

The fact that the debt has been rising by $40 billion a year, as I mentioned earlier, suggests that to cut back on an increase is going to require the developing countries to step up their adjustment process. But obviously they cannot step up the adjustment process so rapidly to eliminate the need for borrowings entirely, so it becomes important for the commercial banks in my industry not only to roll over the old debt, but continue to grow the new, to permit the adjustment to continue, although we all believe that the growth will be substantially less than the $40 billion a year we have had in the previous period.

Now, under these conditions what is needed is good management of the problem on both sides. The overseas governments, the developing country governments, need to speed up their own adjustments, to reduce their current account deficits through appropriate exchange rate and domestic monetary fiscal and interest rate policies.

I think that the subject is often presented as a problem which is the result of deteriorating terms of trade or slow growth internationally, which certainly complicates the situation of the LDC's. But I think in 9 cases out of 10 in the individual situations the problem is created by something the government is doing domestically which leads to a weak balance of payments, regardless of the international situation. So the focus is on the domestic policies and that is where the role of the International Monetary Fund is so important for us.

Since we are basically talking about creditworthiness of a country, it is also critical that the governments do all within their power to pay their foreign obligations on maturity, since they will be needing to borrow anew and creditworthiness is a critical factor in the decision to make new loans available.

The commercial banking system, of which I am a member, went through a phase when we were building up this indebtedness from a

rather small figure to a figure of over $400 billion, and that was essentially an uncoordinated effort. Each bank was doing its own thing.

We now enter a new phase which I think Fred described very well, where we not only have to hang in there, we have to maintain our present outstandings where the countries have good financial programs, but we also need to grow them. That involves a new level of coordination among the commercial banks which we have not had in the past.

Mr. Chairman, I would be very happy to talk about this in more detail later on.

Fortunately, the commercial banking industry is in the process now of organizing itself to deal on an industrywide basis with these situations, something that we have not had in the past and something that I think will be absolutely essential when we have a new situation here of maintaining outstanding levels of indebtedness, and where we have a couple of bad performers we cannot let a few apples spoil the whole barrel.

We are actively engaged now in the process of creating mechanisms to achieve this greater cooperation among the banks. On the borrowers side, we will need good financial programs in order to provide a reasonably good balance of payments performance, so that debt can be serviced, creditworthiness maintained, and new credits extended. For this purpose, the International Monetary Fund is our most key agency.

I would like to subscribe to all that Fred said about the importance of the Monetary Fund. We agree that the quotas should be increased. I would hope that the Fund's quotas would go from the present level of $60 to $70 billion to $100 billion. We also would be in favor of a new Witteveen Facility.

I do have one suggestion to make in this regard, however. I think that the process of going to the Congresses and Parliaments of the world for the quota increases and the Witteveen-type facility may take a very long time. I would urge your committee, Mr. Chairman, to consider the possibility of another and perhaps quicker method.

That would be to alter current IMF policies, and this can be done at the board of directors level with the participation of the executive director from the United States, to alter current IMF policies to permit special programs not tied to amounts of the IMF quotas. These would be specific safety net type activities.

Where funding is concerned, if, as Fred pointed out, there were not sufficient funding for some of these transactions, I would suggest the Monetary Fund be authorized for the first time to turn to the private captial markets of the world, as the World Bank already does. These have the advantages of being simply policy-type measures. If we decide collectively to do them, we can proceed with them forthwith. They do not involve going back to the countries themselves and obtaining new authorizations.

It is a question of the community agreeing about the desirability of safety nets in the near future that are not related to IMF quotas and that, in the necessary cases with funding from the private sector, would be acceptable from a policy point of view.

Thank you very much.

[Mr. Clark's prepared statement follows:]

PREPARED STATEMENT OF GEORGE J. CLARK

Mr. Chairman, my name is George J. Clark and I am an Executive Vice President of Citicorp.

Recent developments (especially regarding Argentina and Mexico) have raised the question of whether there may be excessive commercial debt outstanding to the developing countries.

Between 1973 and 1981 the long term foreign debt of the 109 non-OPEC developing countries increased from $97 billion to $437 billion. By 1981, the annual total of these borrowings was adding approximately $40 billion a year to those outstandings.

The growth of this indebtedness has been nearly paralleled by the growth in foreign exchange earnings of the developing countries since 1973. Consequently, the ability of the developing countries to earn sufficient foreign exchange to service this indebtedness has gone up nearly as fast as the debt itself. Nevertheless, the absolute amount of the debt is now large and this raises the question of whether a liquidity problem might arise. Since a substantial amount of this indebtedness matures each year, the developing countries are faced with the need for additional borrowings regularly in order to be in a position to meet those maturing obligations (and also to finance any continuing deficit in their current account).

A part of the apprehension about this indebtedness results from the fact that the international financial press presents the subject poorly. For example, they commonly pose the question, "Will this debt ever be repaid?" The way of government borrowing works (and this is relevant to U.S. Federal borrowing, State and Municipal borrowing as well as foreign government borrowing) is that virtually all old debt is paid off by the issuance of new debt. Just as we don't expect that the U.S. Government will be reducing its indebtedness, so we don't expect that foreign government borrowers will be reducing their indebtedness. What we do expect is that the borrowing governments, domestic or foreign, continue to carry out good financial policies and pay their obligations on maturity so that their creditworthiness is sustained, so that new issuance of debt can be made. To assure that good financial policies are carried out abroad, we often rely on programs with the International Monetary Fund.

The fact that old government debt is normally paid with new government debt reflects the fact that there is no such thing as bankruptcy proceedings for government lending whether the governments are domestic or foreign. Governments do not go into financial liquidations. Any government may follow poor financial policies and may thereby weaken its credit standing with the banks. Under such conditions, the banks will reduce their loans to that government until a new and more financially responsible government emerges. The disciplines involved (so that the credit standing of the government is maintained) are very strong.

Perspective on the problem can be obtained by recalling the widespread concerns expressed here in the United States only a few years ago regarding state and local government debt. The importance of credit standing, in order to incur new debt, was so strong that far reaching measures were taken to balance budgets, with the result that those problems of a few years ago are now largely forgotten. Many foreign governments have gone through similar phases in the recent past (Peru, Brazil, Turkey) and are now considered strong credits.

When one understands this revolving nature of public sector debt, as discussed above, the weight of its burden is considerably lightened.

Much of the current concern reflects a fear that the commercial banks may overreact to such situations as those currently in Mexico and Argentina. If they did so, it would be possible to create a liquidity problem as governments find that they are being called upon to pay off much of their foreign borrowings in a short period of time without the issuance of sufficient new loans. To some extent, this happened in 1981 in Yugoslavia, Hungary, and Romania as a reaction to the Polish situation.

The total of the debt outstanding is now in excess of $400 billion. The fact that it has been rising means that the developing countries have not fully adjusted to self-financing. Consequently, a cessation of increases would imply major adjustments in the LDCs which could imply severe short term political and social strains. Consequently, some increases in outstandings are called for although at a significantly lower rate of increase than in the recent past.

However, it may be that the commercial bank lenders will now seek a pause or even a cutback, in their outstandings in view of these most recent developments. This could cause short term liquidity problems even in countries which are following sound financial policies.

Under these conditions, what is needed is good management of the problem on both sides. The governments need to speed up their own adjustments to reduce their current account deficits through appropriate exchange rate, and domestic monetary, fiscal and interest rate policies. Since their creditworthiness is at stake, it will also be critical for them to make on time all payments of interest and principal due to their creditors.

On the other side, it will be equally critical for the creditors to recognize that an overreaction on their part could produce severe liquidity problems. It will not be sufficient to simply hold to present exposure levels. There must be some growth in exposures, where creditworthiness has been maintained, while these LDCs speed up their adjustment process.

Insofar as the commercial banking system is concerned, we need to coordinate our activities to assure that a few banks withdrawing from the market do not produce a wide-spread withdrawal. The phase of growing the indebtedness was an uncoordinated one, and the overall objective of intermediating the OPEC surpluses and the LDC deficits was rather well done. However, the new situation calls for commitments to maintain outstanding levels of indebtedness, and even grow them moderately, by all participants. We are now actively engaged in the process of creating mechanisms to achieve this cooperative effort among the banks.

On the borrower's side, we will need good financial programs which will provide for reasonably good Balance of Payments performance so that debt can be serviced, creditworthiness maintained, and new credit extended. For this purpose, the International Monetary Fund is a most important agency. Consequently, we urge the support of your committee for significant quota increases for the International Monetary Fund. Since the quota increase process will take time, we also urge the development of the safety net process under the administration of the International Monetary Fund and with full conditionality. There are two potential ways to finance the safety net. The first would be to ask for authorization by the Congresses/Parliaments of the world for the proceeds. A second, and perhaps quicker method, would be to alter current IMF policies to permit special programs not tied in amounts to the the IMF quotas, with funding, if necessary, to be accomplished directly from the private capital markets. Mr. Chairman, in view of the importance of arranging the facility promptly, we urge your committee to consider this latter alternative.

Senator MATHIAS. Thank you very much, Mr. Clark.

Mr. Garten.

STATEMENT OF JEFFREY E. GARTEN, VICE PRESIDENT, LEHMAN BROTHERS KUHN LOEB, INC., NEW YORK, N.Y.

Mr. GARTEN. Thank you. Mr. Chairman, it is a pleasure to be here to participate in these hearings.

I think the first two witnesses have done a fine job in covering all of the basic issues, and rather than repeat some of the points which they made, let me just make a few by way of introductory comments.

I also believe that the situation is an extremely serious one and that some parallels from the past may not be exactly applicable to the current situation. I think it is particularly important to underline the psychological elements.

I do not believe, for example, that the solvency of the banking system is at stake. But I can see where extensive reporting of the economic problems that some of the major developing countries are facing, coming on top of other news concerning the unprecedented wave of bankruptcies, could create a crisis of confidence in international banking; and that this could have adverse impact on the ability

of banks to lend at reasonable rates and to fuel the recovery for which we are all waiting.

Likewise, I do not believe that it would be the intention of commercial banks, which after all have participated constructively in the economic development process, particularly over the last several years, to precipitously cut back on their lending. Nevertheless, this is a very heterogeneous group and it is possible, it seems to me, that for psychological factors the continuation of lending may not proceed as we all hope.

The second point I would like to make has to do with what some people, perhaps on the extremes of the debate, feel would be a wave of defaults or debt repudiation. It is my view that nearly all developing countries understand the enormous stake they have in either retaining or regaining their credit standing and that they are very unlikely to repudiate their debt if there is any choice at all.

Likewise, creditors have very little interest in formally calling a default. But I predicate this relatively sanguine view, that is, that this kind of problem is not one we need to worry about now, on some economic improvement in the world situation in the foreseeable future. I think that if the recession gets worse or if oil prices increase precipitously, all bets are off, as to how creditors and debtors are likely to behave.

Third, I would like to comment on continued bank lending. I, of course, subscribe to the view that this is very healthy and important. But to get at the question of the banking system for the future, one needs to think through the kind of procedures that will avoid on the one hand a cutback in lending and on the other a repeat of what I would call relatively unrestrained lending, which certainly has contributed to the problem that we have.

The trick here is to balance the short term with the longer view. In the short term, it is of utmost importance that lending be kept up and that whatever new regulatory procedures are contemplated not act as immediate incentives for the banks to pull out. But over the long term there has to be procedures which inject more discipline into the system of international commercial bank lending.

Fourth, let me say a word about the adjustment process, which the two previous witnesses have described so well. I guess because I have acted as an adviser to several developing country governments that have been in these kinds of problems, I am a little less sanguine about the adjustment process working so smoothly. I think it is easy to overestimate the ability of economic managers under severe pressure in developing countries to carry out the kinds of reforms that they themselves know are essential.

Surely these will be carried out, but I do not think it will work as smoothly as a textbook analysis might indicate. That goes for the IMF as well. I strongly support an increase in the IMF resources, but I wonder whether just the IMF alone is an insurance that adjustment will take place in the right sort of way. As much skill as this institution has demonstrated and as much support as it deserves, its record in the past has not always been totally successful.

I do not think there is a better solution, but I only want to underline that it is easy to say, "countries ought to adjust," but coming on top

of years of pressure the adjustment process now is going to be more difficult than it has been in the past.

Fifth, as Fred said at the outset, we are going to be dealing with some very long-term problems that stem from the current situation. It used to be that most countries borrowed to invest and to grow. As far as I can tell, for the foreseeable future they will be borrowing simply to repay old debts.

Debt will be driving debt, and as a result this promises to be a vicious treadmill unless growth can be resumed. This of course brings in all the policies which have been mentioned here so far: continued bank lending, expansion of the resources of the international institutions, and the adjustment process.

Finally, let me just make one comment about leadership. Again, I think it is easy to underestimate how difficult it will be to marshal international leadership when it comes to addressing these problems that we are talking about. For we are dealing with issues that have both a very strong public and very strong private dimension.

This is a very unusual situation in peacetime. Moreover, we are dealing with a situation where on the private side there is no mechanism for leadership. That may be one of the strengths of the private system, since so many people making their own decisions when to lend constitute some safety valve in terms of diversification of risk. But in a crisis it is not clear that these institutions are able to act in accordance with a larger strategy or with the right kind of coordination.

On the side of governments, if one only looked at the Versailles Summit and the events since then, it certainly appears that leadership among the allied governments in the economic area, as elsewhere, is sorely lacking.

So when you put the two together, public leadership and private leadership, in an area that combines both concerns, I would say that there is a major challenge.

Thank you.

[Mr. Garten's prepared statement follows:]

PREPARED STATEMENT OF JEFFREY E. GARTEN [1]

POLICY IMPLICATIONS OF THE CURRENT DEBT SITUATION

Thank you for the opportunity to participate in these timely hearings on Third World and Eastern European debt. Debate on these issues is often based on extreme positions. Some people fear the global economy is about to collapse under the crushing burden of debt. Others claim we are in a business-as-usual situation. I believe the truth is somewhere in between. The international financial system is under severe stress. But in recent years other crises have been overcome, and with a sensible policy response, plus some help from an economic recovery, current problems should be manageable.

Nature of the problem

This committee has already been presented with relevant debt statistics. I shall therefore discuss some of the policy implications. Let me first address one subject which has attracted public attention, but which I do not view as a problem right now. I shall then focus on four relevant concerns.

The "non-problem" is the prospect that countries will either repudiate their debts or that creditors will declare countries in default. There is no reason to be-

[1] Vice President of Lehman Brothers Kuhn Loeb, Inc. and adjunct professor of political economy at New York University. The views expressed are strictly personal.

lieve that either will happen on a widespread scale. Virtually all governments understand that economic progress in their countries depends in part on their ability to attract new funds; they are unlikely to ruin their future credit standing by disavowing their overseas financial commitments. Creditors have nothing to gain by cailing default, even if they have some trouble collecting payments on time. In the end, it is in everyone's interest to negotiate some stretching out of debt repayment schedules. Of course, this sanguine picture assumes that global economic conditions will soon improve. If the recession gets worse, if there is no significant economic recovery for another year or two, or if oil prices suddenly take off again, it is not certain how debtors or creditors would behave.

In the current environment, however, there are more pertinent problems.

First, the banking system itself is vulnerable. The spectre of several countries all having trouble servicing their debts, coming on top of the largest wave of corporate bankruptcies in 40 years, could easily weaken confidence in international banking. If this happens, banks could have more difficulty obtaining funds to relend either in the United States or elsewhere. The recovery could thereby be undermined. In fact, the solvency of the banking system itself should not be at risk. But confidence is an illusive factor. And the impact of world-wide press coverage of Mexico, Argentina, Poland, and other nations, and publicity surrounding a few individual banks which might absorb some losses, could create impressions that banking problems are worse than they are.

Second, the already shaky economies of several highly indebted nations could further deteriorate. The immediate danger is that lending to Third World and Eastern European nations, particularly by commercial banks, will slow down. Commercial banks have become major participants in foreign economies. In developing nations alone, they are now the principal source of capital and hold some 60 percent of the external debt. The percentage is much higher in Eastern Europe. The overwhelming amount of borrowed funds is being used merely to repay debts. If commercial lending is cut-back too fast, the existing debt problems will become worse. In addition, countries such as Brazil, the Philippines, or East Germany could join the long list of those now in trouble.

A third concern is that current debt problems are likely to set back balanced economic development prospects in a large number of countries. This would be a loss for the borrowing countries. It is also a serious matter for their creditors, whose debt cannot be serviced if growth stagnates in the countries to which they have lent. The problem is this: as part of belt-tightening programs which indebted countries will need to follow, expenditures for schools, hospitals, roads, and other long-term public investment projects will be cut. And in many countries, private business—the best hope for future production and innovation—will be squeezed, as large amounts of a nation's foreign exchange earnings are earmarked to pay the government's debt.

Fourth, there is a substantial risk that policy decisions taken to address these issues will be partial, at cross purposes, and unrelated to a larger strategy. There is no central authority which speaks for international banking. At the current time, there also seems to be no effective economic leadership among the OECD nations. Complicating the situation is the need to reconcile the private interests of individual commercial lenders with more public concerns about such issues as the international financial system and economic development.

Policy recommendations

A comprehensive strategy for the debt situation would focus on the immediate future and on the longer term.

Short-term.—At a time when a large number of countries are under severe debt-related pressure, a short-term policy response should be designed with the broader picture in mind. There are certain restrictive measures which may make sense with respect to any one country. If these same requirements are simultaneously applied to many countries, however, they could have a deflationary impact on global economic activity. A basic objective should be to help the world economy grow.

The following could be the basis of a short term strategy:

First, debt pressure could be relieved efficiently and without undue fanfare. This would entail generous rescheduling of upcoming payments of principal. In some cases it might also involve some short postponement of a portion of interest payments. Some specific measures could be taken with respect to the major troubled economies. For example, OCED governments could drop their refusal to reschedule Polish debt. These same governments, together with commercial

banks, could move quickly to address the Argentina situation now. And, of course, there should be continued action to assist Mexico to restructure its foreign obligations.

Second, there is a strong need to keep up public and private capital flows even while debts are restructured. The short-term rescue package which Central Banks put together for Mexico was impressive. Other countries may also need similar emergency assistance. There are reports that the Administration may propose an international emergency fund to assist troubled economies. Presumably, the objective is to insure that funds are available when necessary, and quickly. Provided this arrangement does not undermine the IMF, it deserves support from the Congress. As for the banks, there is no obvious way for public authorities to force them to keep lending. But a good deal of high level jawboning cannot hurt. Also, regulators should avoid new disincentives for lending, at least for a while. I will return to this issue later.

Third, it is of course essential that countries whose earning power is not adequate to pay their debts make major efforts to control their spending and to reorient their policies. The IMF is the best vehicle for working with governments to pursue effective financial "adjustment" policies. There has been a good deal of discussion about whether the Fund's requirements are "too tough" or "too soft." This is a difficult issue to assess in the abstract, since Fund programs can vary significantly by country. In the current environment, however, it is especially important that the IMF take into account the global economic situation. In the short run, at least, there is a strong case for programs which are as flexible as possible, while still constituting a credible program of discipline. Overly restrictive programs risk further contracting world trade, as cut-backs of one country's imports translate into export declines in others. At a time when high interest rates, protectionism, low commodity prices, and uncertain capital inflows together impose enormous pressure on governments, prescribed policy changes which require too much austerity and which are enforced with too much rigidity may, in the end, not be accepted by a government. Or else, it may not be possible for a government to successfully implement the measures recommended by the IMF.

Fourth, before this committee in particular, it may be appropriate to raise the issue of how U.S. policy will be developed in the debt area. Because the situation involves so many countries, as well as economic and political dimensions, the question of who should be in charge is not easy to answer. For the last several years, successive Administrations have argued that there is no general debt problem—only a few country-specific difficulties. The result has been a case-by-case approach with no consistent high level policy focus on the general debt issue. But the debt situation is more serious today. It is important now for a very senior group to maintain a constant overview, at least until the situation is under control. It would be significant if some of the country's senior bankers participated in this policy group.

Long-term.—Debt problems are reflections of inadequate domestic and international policies, combined with economic reversals frequently beyond anyone's control. Beyond the immediate situation, then, the problem of sovereign debt now raises a very broad set of issues.

The first is the Administration's approach to those international institutions which have been central in helping countries improve their future economic prospects. In particular, the United States has recently opposed a large scale increase in IMF resources. Undercapitalization could reduce the effectiveness of the Fund. In addition the U.S. Government, including the Congress, has failed to uphold its commitments to the International Development Association, the soft loan window of the World Bank. For a large number of the poorer countries, IDA provides the only hope for long-term investment funds. With regard to the IMF and IDA, America's policies have an impact which goes well beyond the U.S. dollars which are not made available. In both cases the United States is giving a strong, negative signal about the importance it accords to economic stability and growth abroad. And in both cases U.S. action can discourage other OECD countries from making their maximum financial contributions to these institutions.

Second, there is a need for a more effective regulatory framework for international banking as it relates to sovereign lending. In the short term, as I mentioned, the danger is that banks will not lend enough. In the longer term, the problem is to encourage banks to exercise restraint in countries where the risk is high so they will not be left with mountains of debt which cannot be paid. The

Federal Reserve and the Comptroller of the Currency are considering various plans which will cause banks to be more careful in their lending to foreign governments. However, I would like again to underline the need to keep up lending now, and to avoid giving banks an added incentive to cut-back on their loans at this time. New regulations may have to be postponed until more general global financial stability is achieved.

Third, many future problems might be avoided if countries are encouraged to negotiate economic stabilization programs with the IMF before a major financial crisis erupts. In this respect it is important that governments seek IMF assistance at an earlier stage than has been the pattern. The United States and others with clout in the IMF could help by providing strong advice to potentially troubled economies about the advisability of an "early" IMF program. Commercial banks could also be more aggressive in recommending to countries that an IMF presence in a country is helpful to that nation's creditstanding even when serious problems do not exist. For certain categories of countries, regulatory authorities could require an IMF presence for any individual bank wishing to increase its exposure beyond a certain percentage of its capital or assets.

Fourth, there is a need to give special attention to the most effective ways for countries to make the long term domestic economic adjustments which are essential if they are over time to reduce their debt burdens, regain good creditstanding, and get back on a path of steady growth. In this regard, both the IMF and the World Bank, have complementary roles to play. The World Bank has recently begun a lending program to support long-term policy reorientations in such areas as agriculture and energy. These loans have been relatively small so far, in part because of limitations on World Bank resources. Long-term policy adjustments, together with direct assistance to people living in real poverty, is central to economic development for the remainder of the decade. These "structural adjustment programs" of the World Bank deserve strong U.S. support.

Fifth, a revamping of the customary process of rescheduling sovereign debt is necessary. Current procedures are extremely cumbersome. They often involve the debtor's negotiating separately with its bankers, government aid donors, creditors, suppliers, bond holders and with the IMF. The various sets of negotiations are poorly coordinated, and they are frequently marked by long delays in which a country's economic situation deteriorates. There are times when banks and aid donors each try to impose repayment schemes on the debtor which are incompatible. In the end there is no reference to arbitrate serious disputes. The final rescheduling outcome is as much the result of a slugging match among creditors and the debtor as it is of an analytic determination of what a country can afford to pay and still get back on its feet. To improve this situation, a new institutional mechanism is desirable. One idea is for banks, government aid donors, the IMF, and the debtor to get together to establish some groundrules before any one debt renegotiation begins.

Finally, financial stability and trade expansion cannot be separated. Countries now strapped by high debt levels will need to earn their way out by exporting goods and services for hard currency. Open markets in the OECD are, of course, difficult to maintain in a recession. And it goes without saying that a liberal U.S. trade policy depends on the willingness of other countries to reduce their restrictions on our exports. But to the degree that protectionism increases, the debt situation will get much worse. All the more reason to redouble efforts to preserve reasonably free trade. In the next several weeks there will be at least two concrete occasions for the Congress to show its hand on these important questions: The trade-related portion of the Caribbean Basin Initiative, which has not yet passed both Houses, and the instructions which U.S. representatives have at the meeting of the world's trade ministers in November, where trade relations with developing nations are likely to be intensively debated.

Conclusion

One of the distinctive features of the current debt situation is that the margin for error in policy is usually thin. After years of recession, high interest rates, high oil prices, heavy borrowing, and low commodity prices, many indebted countries are reeling from a series of economic shocks. World banking, too, is in a more precarious position than it has been for a long time, as the problems of sovereign debt come on top of a series of corporate bankruptcies. The challenge for the U.S. Government is to recognize the seriousness of the situation and to provide effective leadership in mobilizing international support for sensible policy responses. This is no more than befits our broad security and economic stake in global financial stability.

Senator MATHIAS. Thank you, Mr. Garten.

Mr. Clark, I think if you were to return some day to this room as the nominee of the President to a diplomatic post, you would be confirmed automatically for the delicate touch that you have in describing difficult situations. You said that you thought submitting the quota problems to the parliaments of the world might be a lengthy process. That is one of the most euphemistic descriptions of what we face. That is going to be a heck of a process.

Of course, I have not discussed this with the Treasury people, but I think that was certainly one of the elements of their reluctance to go further in Toronto than they did.

Mr. McNamar will be here in a few minutes and can speak for himself on that.

Mr. CLARK. Yes, we find it hard to understand, really, because there is this other option of turning to the private capital markets. The World Bank did it from its inception. I never really understood why we kept such a Chinese wall up here.

Senator MATHIAS. Very clearly, if we have to proceed under the established procedures it will be a major political issue to get the legislation through this Congress, and I am sure through other legislative bodies around the world.

Mr. BERGSTEN. Mr. Chairman, may I jump in on that for a second, because I think it is a critical question and it goes not only to dealing with the substance of the problem but the confidence that other countries have in U.S. ability to provide the kind of leadership that Mr. Garten was quite rightly calling for.

Senator MATHIAS. Absolutely, I am not saying that it should not be done. I am for it.

Mr. BERGSTEN. I understand your view. But I harken back to my experience in a previous incarnation. It fell to me, as you may recall, to try to pilot the last IMF quota increase through the Congress.

Senator MATHIAS. My wrists have never recovered from that experience. My arm is still slightly dislocated.

Mr. BERGSTEN. But I thought you were doing the twisting and not being twisted. [Laughter.]

As I recall the process, there was really not much substantive opposition to the quota increase. We had delays. There was one long delay over the accounting treatment, how was the quota increase to be treated in the budgeting process. There was another delay when one of your colleagues in this esteemed body decided to hold up this particular piece of legislation because of what was happening to some other pieces of legislation that he cared about.

But as I recall the process, the degree of substantive opposition was really rather modest. I recall too that the outcome on the accounting side was not to treat it as a budget outlay or an item that added to the budget deficit, and therefore that particular concern which is so much on everyone's mind now, quite rightly, the level of the budget deficit, is not really directly at issue.

So I just wonder whether it really would be all that difficult. And I have to say in addition, I have greatly admired the ability with which the current administration has been able to win congressional approval for lots of major pieces of legislation, including in this international area. I would have thought that, given the difficulties of the

situation, given what I think is a fairly wide consensus on the importance of the IMF role, could it not be done much more quickly than is being suggested?

Senator MATHIAS. I think you have a point. This is a fairly esoteric subject. Now, when you talk about giving arms away, people understand that. That is very basic. If you were going to give $1 billion worth of Springfield rifles away, that would be easily understood. If you were going to give $1 billion in cash away, that is easily understood, or $1 billion worth of agricultural products.

This is much more complex. This is a case where, Mr. Clark, I think less understanding sometimes makes the job easier.

Mr. CLARK. I must say this, though, Senator Mathias. I think the various observers in the field have differing points of view. On some things we disagree violently, and so on. But I do not think I know of any responsible person who is living with this problem today who does not feel that that process is absolutely essential. And the only thing we are debating about is whether it ought to be 25 percent or 50 percent or 100 percent. We have to have a bigger IMF.

Senator MATHIAS. I concur in that view. One of the reasons we are here is to try to see how we can make it happen. I would just like to point out to Mr. Bergsten, however, that the legislative process really doesn't begin here on Capitol Hill; it begins at OMB and the White House, and that is where some of the problem exists. Not out of any spirit of meanness or parsimony, but because they are faced with a melon of a certain finite size and they have to make the first cut on that melon.

So, Fred, that is where part of the problem exists.

Mr. BERGSTEN. I think that is true, Mr. Chairman. We all know the iterative nature of the process between the two ends of Pennsylvania Avenue. I think some in the administration have quite sincerely been hesitant to proceed with the IMF quota increase because of the fear that it would be difficult to handle here in the Congress.

Some may also have hid behind the Congress, but I think some sincerely have that concern. I think it would help, quite frankly, if you and your colleagues in the Congress who understand the issue and are supportive of it in the way you were expressing in these hearings today would make that very clear to the administration and in public. I think that would help galvanize the people at the other end of the street to come forward with an energetic proposal.

Senator MATHIAS. I am perfectly frank to admit that I see the absolute necessity of this, and that the disaster that could flow from not doing it is so much greater than the problems that would flow from doing it that I think we really have no choice. I think Mr. Clark is right when he puts it in those terms.

Mr. CLARK. Another thing that happened, Mr. Chairman, that reflects the administration's point of view is that at about the time the administration came into office, we had a few weak programs. The Fund was going through a phase of what we call weak conditionality. The administration was concerned at that time, and I think they were right to be concerned. But thanks to efforts on the part of the administration and others, including the commercial bankers, we told the Fund that we had to have strict conditionality.

I think they turned the corner about 18 months ago, and I would like to say that we put a lot of money out to support the Fund programs and we feel that since that glitch in the process, which was not very longlasting, the Fund is really doing very well on conditionality. And we try to take every occasion we can to reassure the administration and our friends everywhere. They are really running a fine shop down there right now.

Senator MATHIAS. Mr. Garten, you said that debt will drive debt unless we can achieve some period of economic recovery on a global scale and look to some expansion of the global economy. This really means that until those conditions change, governments are not going to repay their debt; they are just going to roll it over, doesn't it?

Mr. GARTEN. Well, sir, as Mr. Clark said, I am not sure the issue is whether they repay the principal or not. I was looking at it from the standpoint of what they are going to do with their foreign exchange.

Unless these countries are able to grow, I think that more of them are going to have problems merely paying their interest, let alone the principal. The reason is, as Fred mentioned, when you take into account not just the medium- and long-term debt but also, the short-term debt, virtually all of the money that many countries are borrowing is going to be recycled back to the creditors.

I would add one other dimension that makes it, I think, even more serious and that is the question of the foreign debt of the private sector in developing countries. This is one area where we really do not know the statistics. Some of the best estimates are that around 25 percent of the total foreign debt may belong to the private sector.

There are also claims on the foreign exchange earnings of a country. If a country is exporting and earns, say, $100 million in a month, that has to go not only to repay the debt of the government, but also, the debt of the private sectors which over time are probably the best hope for expansion of the economies.

So when I say debt is driving debt, what I mean is there is likely to be very little money left over for the kind of investment that would make growth possible.

Senator MATHIAS. Well now, I want to get to that because Mr. Clark said that the debt must not only roll over but grow.

Mr. CLARK. Yes.

Senator MATHIAS. If we are going to absorb all of the available hard currency in a country to service its external debt so there is no possibility of growth, what weight do you and Mr. Clark, as private bankers, put on that situation which must have in it some risk of political instability? Some risk of bringing down the incumbent government? I do not mean by revolution, but countries have elections and follow democratic procedures. They do not always keep in office the people who are not bringing in the bacon.

Mr. BERGSTEN. And not just in developing countries.

Senator MATHIAS. Well, I did not want to get too close to home. [Laughter.]

Mr. CLARK. Mr. Chairman, if I could comment on that because we are talking about the role of the commercial banks here. I think the commercial banking industry recognizes that we are entering a new

11-299 O - 83 - 4

phase now. We are growing. Debt is one thing, but managing large outstandings is something else again.

We are starting to organize ourselves. We had our first industrywide meeting in Ditchley, England in May, and we are having our so-called Ditchley–II in October in New York. Here, the effort is to discuss precisely these problems. We visualize the situation where we will have annual consultations with the countries, similar to what the International Monetary Fund does, and where we will have a representative group of bankers to discuss with the authorities what their financial needs are, what the policies are that they are following and how we can work with them to maintain their present debt situation and grow it when the conditions are proper.

And we quite agree with Jeff's point that there has to be new money coming in from the commercial banks in order to help them with the new investments. That is what we have been doing for the last 8 years, and we expect that process to continue.

I want to emphasize again that it is critical that we do have the right financial programs with those individual countries so that they are credit worthy and so that we can grow the indebtedness.

Senator MATHIAS. You referred in your statement to uncoordinated bank lending in the seventies.

Mr. CLARK. That is the way it has been.

Senator MATHIAS. Yes, that is the way it has been. Now you talk of coordinating.

Mr. CLARK. That is right.

Senator MATHIAS. I would be interested in the views of all the panel members on this. If you agree that some coordination is necessary, what kind of coordination do you believe it should be? Are you thinking of a more active role on the part of governments? Are you thinking of combinations of banks? Does this get you into antitrust problems?

Mr. CLARK. First of all, Mr. Chairman, we think this is a commercial bank situation. I mean, the amount of indebtedness that we have talked about, and we think it is up to us to handle our own problems in this regard. We are not looking to Government to tell us what to do or to bail us out. That is point No. 1.

Point No. 2 is this. Regarding coordination, we do have to have our lawyers very much in the room because there are limits to what we can do. But we can talk among ourselves about the need for each individual bank to maintain its total outstandings.

By the way, in this regard we would include both short term as well as long term, bank by bank in a situation like Mexico and Argentina until we can bring in an orderly process out of that. We call those standfast agreements. They have been used for many years in domestic commercial bank lending. The only thing that is new here is we are now starting to develop our standfast agreements where we have countries' sovereign risk involved and short term, long term, private, and government. It all has to be in there.

But that is an industrywide effort, and I do not think we really see that it would be advantageous for anybody to involve our Government in that process.

Senator MATHIAS. Is there any comment from the others?

Mr. BERGSTEN. I would simply endorse the principle. I think as one looks to the longer run resolution of this problem a critical question is: How do we avoid all this happening again? How do we avoid again this situation where the debt burden becomes so heavy, as enunciated today? How do we avoid the exposure of the banking system becoming so heavy relative to its own capital or whatever? We do want to avoid this happening again.

Whatever is done in the short run to deal with the immediate problem, we have to be thinking simultaneously about how to keep this from popping up frequently in the future.

Now again, as we have all been saying, a large part of the problem is the stagnation of the world economy, and we certainly hope that that does not occur more than once every 50 years or so, as is now the case. But it might, and so we have to be prepared to handle it and avoid the implications thereof on the financial side.

So clearly, some kind of improved mechanism is needed to assure that we do not now get an excessive rate of lending of this type. That obviously is going to include the demand side, the borrowers, as well as the supply side, the lenders.

I am not sure what the right mechanism is. I think the banks are to be credited for trying to work out their own system to help deal with it. Whether that is the right system, or whether that is enough vis-a-vis public authority, either domestic or international, I am not sure, but it is certainly a step in the right direction. And I think that element of the problem is going to have to be dealt with as part of it.

Mr. CLARK. Senator Mathias, at least as far as the United States goes, we have the fortunate tradition of not having the Government overly involve itself in commercial bank activities. I think we are lucky to have it that way.

In Europe—and Fred knows this about as well as anybody—you do have the governments telling the commercial bankers what to do to some extent. One of the things they told them to do in 1979, 1980, and 1981 was to lend to Poland. The result was that European banks have a great deal of Polish exposure, which is at their own risk, but it was prompted by the governments.

Senator MATHIAS. Not all of it at their own risk.

Mr. CLARK. No, but some of it.

Senator MATHIAS. The Federal Republic of Germany has underwritten a good deal of it.

Mr. CLARK. Yes, and the banks also have a lot of their own. I just think it works better, and I think most of us believe that that tradition in the United States has worked well.

I think one of the dangers of the present situation, is that that tradition that we have might have some forces at work on it to break it down. That could be very important. Most of the debt we are talking about is commercial bank debt, and by and large, the commercial banks should handle that problem on their own, in my judgment.

Senator MATHIAS. Thank you. Mr. Garten.

Mr. GARTEN. I agree that it is important that the banks get a better handle on the lending process, and certainly, the past several years have not reflected any coordination at all; in fact, the situation has been quite the opposite.

Whether or not the banks as a group have the capability to coordinate on other than the lowest common denominator basis is something I think that will have to be seen. But I would just want to underline that I think we are dealing here now with something that goes well beyond a commercial issue.

It may have been an issue of commercial lending several years ago. There are broader ramifications now that relate to international financial stability and the political questions that you are beginning to get at—what types of governments are we going to be dealing with; what is going to be the impact of financial austerity on our security relationships; what is all this going to mean for the system of international trade, which obviously has very vital and direct interest to our economy?

I for one do not believe that the answer is only in commercial banks taking hold of the situation. As good as the coordination may be, I think it is unreasonable to expect that their considerations will go much beyond the commercial. That is what their strength is.

So I would just want to add that I think there is a major role here for public authorities, both in terms of regulations and in terms of the active role that governments ought to play.

Senator MATHIAS. Well, reserving my own judgment as to which of you is right on this point, let me say that I heard Mr. Clark when he said the lawyers are always in the room. Heaven forbid that I restrict my brothers and sisters at the bar from making an honest living, but I am not sure that you always ought to feel that that is necessary.

It may be that we should review the antitrust laws in this respect to provide more freedom. I have a feeling—and this is a view that I have expressed in another committee—that the antitrust laws may not be in all respects appropriate for the international economic climate of 1982.

I think we have to look at the realities of the American economic system today to see if some adjustments are necessary. I have been working on that, and this is an example of that possibility. I do not have any fixed view that this is an appropriate case for some change in the antitrust law, but it is the kind of thing that I think ought to be looked at.

Let me ask you this. From 1971 to 1981, the external debt of developing countries increased from $87 billion to $524 billion, which was an average of about 20 percent a year. Now, what is the really big worry? Is it the ratio of debt to export earnings or to total GNP, or the ability of countries to service the debts?

Mr. CLARK. Mr. Chairman, I do not think it can be reduced to a ratio thing. I think Fred really put it very well. It really depends on what the individual country is doing. We have countries with a very high level of debt; much of it very short term, and they manage their affairs well. They roll it over and they borrow increasing amounts. It goes up and maybe the ratio to exports is very high.

Then you have other countries that have really very little foreign debt in relation to any ratio, but their policies are so bad that they cannot even follow the limited debt servicing that they are faced with.

I think the one critical thing is what the countries themselves are doing to deal with their own balance of payments problem. That varies all over the lot. You have the really good performers like Brazil, and then you have the perennial laggards.

That is where the Monetary Fund is so useful.

Senator MATHIAS. Like the good diplomat, as I have identified you, you do not name the laggards; you only name the good guy. [Laughter.]

Let me ask Mr. Bergsten this, because he and I have agreed that there ought to be an increase in the quotas and there probably ought to be some short shot in the meantime because of the lag in getting the quota increases activated.

Almost 90 percent of the developing countries' debt, or at least the servicing of developing countries' debt, is being paid to commercial lenders. And only 10 percent is going to aid donors or to official lenders. So are we right in saying that there has to be some increase in the capacity of the public institutions?

Mr. BERGSTEN. Well, I think so, for two reasons. One is the catalytic effect of the programs of the official institutions. It is quite right to say that the overwhelming share of the debt is owed to private lenders. But for the reasons we have been indicating throughout the hearing and in my own initial statement, there are times of trouble when the injection of the IMF or even the World Bank, through a structural adjustment loan or whatever, may be an extremely important signal to the private lenders that the country is pursuing appropriate policies and, therefore, deserves continued support from them.

So the catalytic role is terribly important. And I would hazard a guess that some of that lending in the past which has been needed and appropriate might not have gone had it not been for the Fund and even the World Bank playing an important role. But that is only a part of it.

I stressed in my statement, but I reiterate because it is terribly important, that in the future I think we have to work on the assumption that a smaller share of the smaller LDC deficits will be financed by private lending.

Mr. Clark said that whereas the private banks contemplate continued growth in their involvement in the developing countries, they envisage that growth at a slower rate than it has been in the past. There are some who would worry they might not even do that, that they might cut and run. I have said that would be a disaster. Mr. Clark and Mr. Garten have both agreed and said they do not think it is likely, but we have to work on the assumption that the growth rate of private lending to developing countries is going to be substantially less in the future.

That means that somebody has to pick up at least a part of that shortfall. I say part because, as part of this whole process, the developing countries' adjustment will require them to reduce the total level of their deficits and, therefore, the total demands that they have for external finance. But even with that reduction, the share of the private banks or other external private lenders is going to go down. The only way to meet that shortfall is by an increase from the public side.

Now, let me get back to your point about the Congress here and parliaments elsewhere. Budgetary appropriations are obviously going

to be very hard to come by. There is a need for it. It ought to be tried, but it is going to be very hard to come by. We know that.

It therefore seems that the peculiarly unique role of the World Bank ought to be brought to bear. The World Bank, after all, is primarily a financial intermediary using very little, if any, in the way of budgetary appropriations, but rather borrowing in the private capital markets and relending that money at market or near market terms to the developing countries.

It seems to me that that unique feature of the World Bank places it in a particularly strategic role to step in and pick up at least some important part of this shortfall between what will continue to be needed and what the private banks will be able to do within their own prudent requirements.

So I would say that for the future even more than in the past, the public institutions are going to have to play a big role, and the 90 percent figure is probably going to decline, or it should decline in the future, unless we are to ask the developing countries to retrench so fast that it puts major further downward pressure on the world economy and intensifies the problems of internal stability and security implications that have already been raised, and I think quite rightly, in these hearings.

Senator MATHIAS. I agree with what you say. But is there also another valid reason? If Mr. Garten and Mr. Clark as private bankers tried to dictate to a government some fiscal restraint and some economic disciplines, the concept of an American bank of Wall Street imposing its will on sovereign governments would b politically difficult. Whereas, the international institutions representing the voice of the collective world community are more acceptable as disciplinary bodies.

Mr. CLARK. Mr. Chairman, if I might comment on that, what has evolved over the years has been that we have also found that to be a thankless position to be in. In 9 cases out of 10, the way we resolve it is by requiring that they have an extended fund facility or a standby arrangement with the Monetary Fund, so that we are all sure that they are following the programs of the Monetary Fund.

That I think is a very convenient way out of the dilemma you pose, and you pose it quite accurately. It is also a reason why we all perceive the Fund to be so critical, because they can go in. It is their role, in fact, to go in and make those kinds of requirements. And they are technically competent to do so.

Senator MATHIAS. They are like the country lawyer that always has to have an evil partner.

Mr. BERGSTEN. Somebody has to be the bad guy.

Senator MATHIAS. The country lawyer will always agree to any settlement, but his evil partner would not possibly allow it.

Mr. CLARK. I do not look upon them as the bad guys; I look upon them as the people who try to remind the governments what the real world is all about. That really is the role of the Monetary Fund. They just say you cannot afford these deficits or that exchange rate, or, if you have that interest rate policy you are going to have a balance of payments deficit.

That is the kind of role they play and it is enormously useful.

Mr. BERGSTEN. I think the point is worth elaborating on in the following way as well. The main objection to this role for the IMF in

the past has come from those in developing countries and elsewhere, including some industrial countries who have felt that the Fund was too tough and was not adequately taking into account the social and political realities in the country in levying these terms.

That was, in fact, the main reason why my institute undertook the study that I mentioned before, which we published about 1 month ago, which looked in great detail at a dozen or so of the most controversial cases of IMF lending over the last 5 years, and concluded that on the whole, these charges that the Fund was guilty of overkill, of requiring too much, of being insensitive to the conditions in the developing countries, just did not stand up in the face of careful analysis and extended discussion.

We agreed with Mr. Clark, incidentally, that the Fund may have loosened up a little too much during the early 1981 period. We think maybe it tightened up too much over the last year, given the difficulties of the world economy. But we certainly feel that over time it has carried out a balanced and effective approach. And when it called for tough programs, as in Jamaica, Turkey, and a few other places including Tanzania, it is because the situation was desperate and that is what had to be put into place.

So when I say they are the bad guy, it is kind of the messenger bringing the bad news, but carrying news of what had to be done.

On the basis of what I think is the most thorough analysis to date of this issue, and a conference where people from all different ideological stripes were involved, there was an almost total consensus that the Fund has done this job effectively.

So arming them with the resources is only part of it. They obviously have to be accepted and acceptable in the countries that have the problems. But we certainly found that their record would give strong reason for them to be so.

Senator MATHIAS. Mr. Garten.

Mr. GARTEN. While we are on the subject of supporting the IMF, I would like to make the point that it is fine to say that countries that need to follow adjustment policies or to have a program with the IMF, we all agree with that. But in the context that we are now dealing with, both short-term and long-term, there is another issue here, and that is this.

If the IMF were to prescribe a program for a particular country and also judge that it is important for a certain level of capital inflows to be forthcoming, would lenders support that? We all agree that lender support, when IMF presence is falling apart, is vital. And nobody can do that job. But many of the IMF programs have to deal with the situation as it is, as Fred says, imposing very tough conditions because there is no other choice.

But if the system were to really work and if everyone were to put as much faith in the IMF as he has said he would, then I think that when the Fund says a certain level of capital inflows is required in the future, all leaders should pitch in. I mean, one wants to have it only one way, but I think it has to be both ways.

Senator MATHIAS. Let me ask you a somewhat related question. It is whether the Eurocurrency market and the other offshore banking centers have made their banking regulations obsolete. Has the fact that

there are these pools of capital made a difference as far as coordinating and regulating the system goes?

Mr. GARTEN. Well, in the first instance the existence of the Eurocurrency market was an invaluable mechanism to efficiently recycle the OPEC surplus to borrowers who needed the money. Looking ahead, there is wide acknowledgement that the question of international banking supervision, which would include those lenders that participate in the Euromarket, needs increasing tightening up.

I would not go so far as to say that all banking regulations are obsolete, but there is a very major focus now on creating a supervisory structure which catches those elements such as the Italian Bank, where good supervision does not exist right now.

Senator MATHIAS. While we are talking about discipline in this particular marketplace, let me pose this further question.

We have talked about increasing funding for the IMF. There are those who maintain the Puritan tradition that if there were more money available the IMF would not be the disciplinarian that it is, that its regulations would be more lax, that it would not be the taskmaster. Do you think there is any validity to that?

Mr. CLARK. Mr. Chairman, those who are reluctant about having to go to the capital markets, I think that is the principal question that they raise. I frankly do not really understand it because the policies of the fund are collectively arrived at by the directors and the managing director. They meet together.

The major governments—the United States, the United Kingdom, German, Japanese, and other governments—if they perceive that a policy is weak, they approve those agreements one by one. I cannot imagine that an erosion process would take place if the governments did not want that erosion to happen.

We would hope that conditionality would stay high. We would hope that the major governments would want it to be that way and that the management would want it that way. You are not sure what will evolve over time, but it would be our hope and our belief that the governments can control that process absolutely.

Mr. BERGSTEN. I would agree with that. From my own experience in dealing with the institutions, program control can effectively alter the degree of conditionality or nature of programs that are carried out by the fund.

If there is any fear of that in the current administration. I would think it is particularly misplaced. They have demonstrated an ability, all too much for my taste on some occasions, that they are able to achieve their objectives through these institutions. So I would think that is really a misplaced fear.

I would make a comment on your previous question, if I might, about the impact of an increasing array of financial markets for the regulatory process. I think the implication is that in the future, to be effective, the regulatory process is going to have to be internationalized to a much greater extent than it has been heretofore. There are many instances now in which purely national supervision and regulation of financial or any other institutions——

Senator MATHIAS. You will drive some people up the wall by that recommendation. They do not want Federal regulation, let alone international regulation.

Mr. BERGSTEN. That is right, but I think that view simply ignores the reality of the current world. Interdependence is a cliche, but it is also a reality. It is becoming more intense every day, particularly in financial markets which are wholly operated on the basis of instant communications around the world.

To seek to regulate effectively on a purely national basis is really very hard to conceptualize now, let alone carry out in practice. There have been some efforts already in the past and for different reasons to try to develop some international organization at least of regulatory efforts.

I think one thing we learned from these current events that we are talking about is the need to bring our supervisory mechanism up to speed, and one aspect of that is going to be to do it much more consciously on an international basis.

Senator MATHIAS. I wonder if you and Mr. Garten would like to comment on Mr. Clark's suggestion that as an alternative to increasing the quota with some quick injection of additional capital we might alter the current IMF practice to permit turning to the private capital market for, as I understood it, specific projects.

Mr. CLARK. Yes, sir. There were two components to that proposal. One would be to turn to the private capital markets for financing, but, No. 2, on an ad hoc basis, country by country, to divorce the total amount of the extended Fund facility or the standby from the quota. The Fund policy today follows a limit of making 150 percent of quota available per country for a 3-year period, for a total of 450 percent.

This proposal would, in ad hoc, specific situations, drop that limit and if it were deemed appropriate a country might have five times or eight times its quota available in 1 year if the Fund, board, and management felt that was desirable—both components——

Mr. BERGSTEN. As to the borrowing in the private capital markets, Mr. Chairman, I think in principle there is no objection to it, but I do think it is a little like the beauty contest story: Having seen A, we choose B. When you say that, because it is difficult to get quota increases and things through parliaments, therefore we go borrow in the private markets, the implication is that that would be quite an easy thing to do and without much difficulty or delay of time the Fund could go out and do it.

That might be the case, but I do not think the proposition has been fully tested. The obvious first question is: Against what collateral would the Fund borrow? It does not have callable capital of the type the World Bank has as pledged guarantee funds to stand behind its borrowings, but it does have 100 million ounces of gold and one could imagine dedicating, at least implicitly, part of that or even all of that as backing for Fund borrowing. If that was done, that might be pretty good collateral.

But I mention that as one of only several issues. There are a lot of questions that surround the issue of Fund borrowing in the private capital markets. On balance, I think those could be worked through and the Fund could position itself to do that. I simply caution that I do not think it is going to happen in 2 weeks and, therefore, it is not something we can just say automatically have the board meet next Tuesday and vote on it and it will happen a week hence. I think it is a little more complicated than that.

I recall when I was at the Treasury Department there was an extended discussion of it back in 1977 and 1978. The Treasury at that time submitted a study on the question and did point out that there were a number of questions, fairly weighty questions, that would have to be resolved to enable the Fund to go ahead and do it.

I think in principle what is a good idea is the Fund ought to position itself to do it. I simply caution that it could do it with all the rapidity that is being implied or that the amounts involved could be as substantial as are needed to deal with this immediate problem.

Senator MATHIAS. It could also be a crutch to avoid the political difficulties that would be involved in otherwise going to governments for increased public funding.

Mr. BERGSTEN. Again, that comes back to the question we raised in the context of conditionality. The same governments who would be asked to put up money for the Fund would also be asked to approve the Fund going out to borrow the money.

Now to the extent the concern is the governments themselves putting up money, then, of course, their answers might be different. But to the extent the concern is the programmatic use of the money, presumably it would be somewhat similar and since there is no budget outlay or budget deficit effect from the provision of money by the governments themselves, I am not sure why the difference would be so great.

Senator MATHIAS. Well, I do not suggest so much that it is the difficulties of the governments putting up money as it is politicians avoiding making commitments to international projects when they have 10 percent unemployed that they have to explain these decisions to.

Mr. Garten, do you have a comment on that?

Mr. GARTEN. I agree with what Fred is saying. It is a more complicated business than is ordinarily appreciated for an institution to enter the market for the first time, especially for the amounts that are likely to be needed.

I think there is also a psychological factor here. If the IMF is anything like a lender of last resort—and I know that is a very imprecise term—there are a lot of people who feel that it should not depend on its funding from the private markets.

Mr. BERGSTEN. Mr. Chairman, if I might just come back, I would comment on a comment you just made. I fully appreciate the difficulty with 10 percent unemployment of saying that any kind of budget authority ought to be put up to the IMF, but I think you can cut through that political problem or at least try to do so very simply by pointing out that an enormous number of American jobs depend on U.S. exports to those very same developing countries.

If they do not get IMF help and outside financial assistance, their purchases of U.S. exports are going to drop sharply and their ability, therefore, to help support U.S. jobs is going to drop sharply. Look at what has happened in Mexico this year. Its imports from the United States are down by one-third over the first 6 months of this year. That is costing an enormous number of U.S. jobs. Mexico is our third biggest market, which takes almost 10 percent of our exports.

There are tens of thousands, if not hundreds of thousands, jobs directly involved. So when we put our support into the IMF, and again I harp on this, we do not increase our budget deficit. When we put up money enabling the IMF to support other countries, we are creating U.S. jobs. It seems to me when we have 10 percent unemployment we want to do that because it is helping our own economy.

Senator MATHIAS. Well, you are singing my song. I have been trying to persuade the State Department to rename the Foreign Assistance program and the Market Development program because that is by and large what they really are. They are developing American markets. It does not sound quite as altruistic, but in terms of being realistic I think it would be a useful change.

Mr. CLARK. That is a very good point and I agree with it.

Senator MATHIAS. Well, gentlemen, we have explored this question at some length and from my perspective in a useful way. I am very grateful to you. I will hold the record open for 3 days. If upon reflection you want to add to anything you have said, we would be happy to have your further thoughts.

Thank you very much for being here. We do appreciate it.

Mr. CLARK. Thank you for the opportunity, Mr. Chairman.

Mr. BERGSTEN. Thank you.

Mr. GARTEN. Thank you, sir.

Senator MATHIAS. Our next witness is the Deputy Secretary of the Treasury, Mr. Richard McNamar.

Mr. McNamar, we appreciate your being here today. I know that you are under great pressure. You are on the active firing line and are dealing with the problem of coping with the international debt difficulties, so we appreciate that you will come here and advise the committee not only on the basis of theory but on the basis of what is actually happening in the world today.

STATEMENT OF HON. RICHARD T. McNAMAR, DEPUTY SECRETARY OF THE TREASURY

Mr. MCNAMAR. Thank you, Mr. Chairman. We appreciate the opportunity and particularly the committee's consideration of allowing me to go at this time because, as you know, the Senate has passed the banking legislation and we are going to conference and I was engaged in that this morning.

Senator MATHIAS. As I pointed out at the beginning of the meeting, one of the reasons we are holding these hearings is to try to get into a position for these particular decisions on the IMF and on IDA VII in order to avoid the kind of crunch from which you are suffering in other respects.

Mr. MCNAMAR. If I may, today I would like to have your permission to read a statement that I think may put some perspective on this question. As I understand it, the rest of the copies unfortunately did not come with me and I just brought mine.

I am pleased to meet with you today to discuss the debt situation of the developing countries and to share our views on what this means

for the global financial system over the next few years. There is obviously widespread and well-founded concern in world financial circles about the present circumstances.

In response, I will offer in these remarks some historical perspectives and current assessments which lead us to the view that—with understanding and responsible self-interested behavior by both debtors and creditors—the situation today, while serious, is manageable, appears transitory and, to a degree, is self-correcting.

In outlining the basis for these conclusions, my testimony will cover the following: the trends of the 1970's, events in the 1980's, the situation in 1982, the present institutional framework for maintaining international financial stability, prospects for the future, and a summary of U.S. policy and timetable for proposed congressional and other actions.

First, the trends of the 1970's. There was indeed an unprecedented accumulation of external debt, both private and official, by developing countries during the decade of the 1970's. At the same time, however, growth in LDC domestic production and export earnings were also mushrooming.

To give you some highlights:

One, during the period from 1973 to 1980 the external debt stock of the nonoil developing countries grew from $97 billion to about $375 billion, while annual debt service payments rose from $15 billion in 1973 to $67 billion in 1980.

Two, absolute figures, however, may be misleading. The rate of increase in debt—22 percent annually in nominal terms but only 6 to 9 percent in real terms—was substantially lower than the real rate of increase of 12 percent during the previous decade of the 1960's.

Three, debt service flows increased at a faster rate than debt itself, reflecting the shift to more private borrowing at higher—market—rates and shorter maturities, but even this growth, at 24 percent per year, was no greater in real terms than during the decade of the 1960's.

Four, again during this period, gross domestic product for these LDC's grew at an average annual rate of 5 percent. Export volumes grew even faster, on an average of 6.1 percent annually.

Five, the result of all this is a mixed set of indicators for the 1973 to 1980 period.

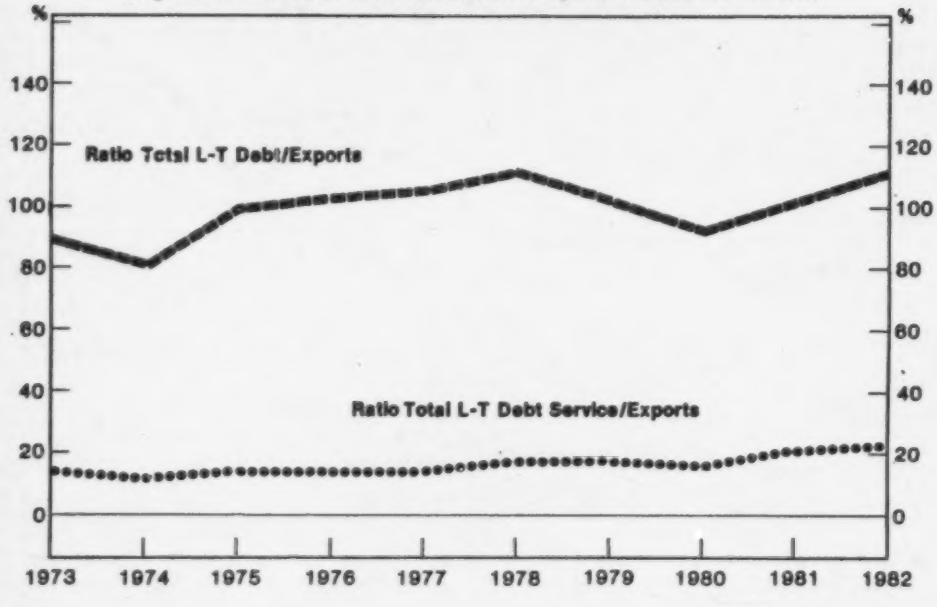
What I would like to do, if I may, Mr. Chairman, is to refer to three charts that we have here and point out one or two salient features about each of them.

The first chart shows the ratios of debt and debt service for the nonoil developing LDC's.

Chart 1

Non-Oil Developing Countries
RATIOS OF DEBT AND DEBT SERVICE

Long-Term External Debt and Debt Service to Exports of Goods and Services



Source: IMF

Senator MATHIAS. Could that be raised just a little bit? Thank you.

Mr. MCNAMAR. You can see that the ratio of debt to exports did not increase nearly as much as the nominal value of the debt itself—really from about 85 percent in 1973–74 period to about 110 percent in 1978, and then a decline somewhat later.

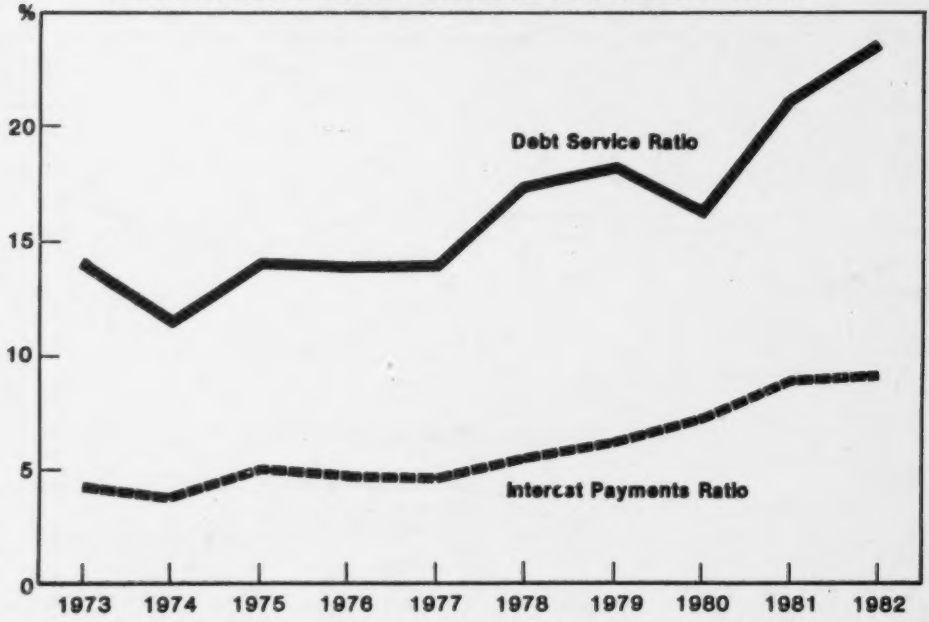
The debt service ratio, which is the ratio of long-term debt service payments to exports, did rise faster than the debt to export ratio. When you look at that ratio on the bottom you can see that over the longer term period the ratio rose from just under 20 percent to just over 20 percent.

If we look at that on a slightly larger scale, in chart No. 2, where that is shown on a scale that instead of running from zero to 160 percent runs on a scale from zero to 25 percent, you can see in the maroon line that the debt service ratio did rise, but you can see that the interest payments ratio rose with it, which is very important to understand.

Chart 2

Non-Oil Developing Countries

DEBT SERVICE RATIO & INTEREST PAYMENTS RATIO



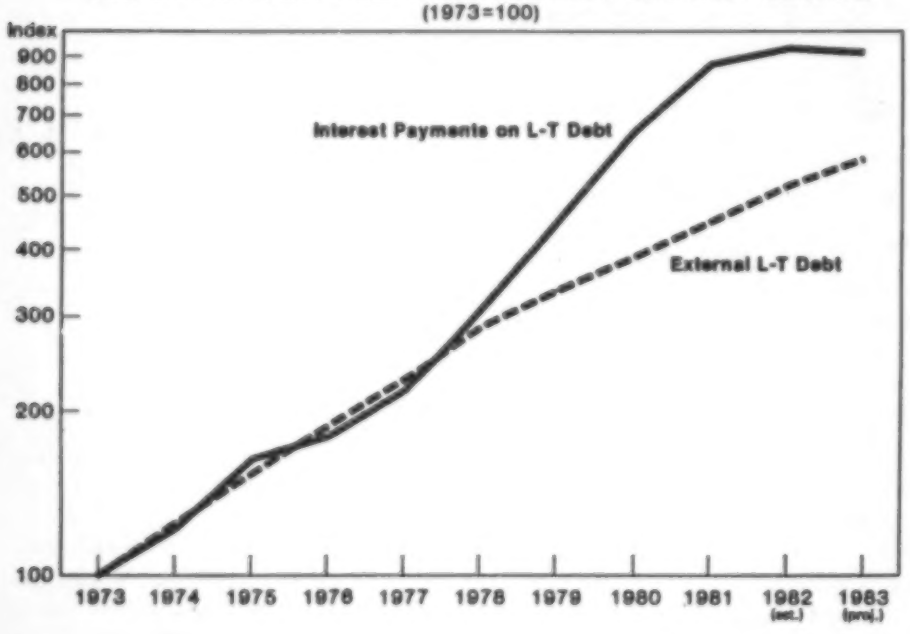
If you turn to chart 3 for a second, I think that you see somewhat more graphically the impact of both the higher percentage of private borrowing and the more market-oriented interest rates that that implies—harder lending as well from the multilateral financial institutions. There you can see debt and debt service plotted on an index basis, with 1973 as the base year. We picked that, of course, because of the Arab oil embargo.

Chart 3

Non-Oil Developing Countries

GROWTH IN LONG-TERM EXTERNAL DEBT AND DEBT SERVICE

(1973=100)



You can see that as you move through the decade, the interest payments on long-term debt grew very rapidly and the external long-term debt as well. That, I think, in terms of debt and debt service probably gives you a fairly accurate picture of what happened.

Senator MATHIAS. Can those charts be swiveled around? The press is having some difficulty in following.

Mr. MCNAMAR. When the press get copies of my statement there will be copies of those charts attached.

The result of all of this, as I say, is the mix that I have indicated for the 1973 to 1980 period, the ratio of debt to exports rose from 89 percent in 1973 to 111 percent in 1978, then fell back to 93 by 1980.

The debt service to exports ratio was 14 percent in 1973 and rose to about 17 percent in 1978–80, but interest payments, as I said, grew more rapidly than amortization payments. The ratio of debt outstanding to GNP moved from a level at the beginning of the period of about 16 percent to about 22 percent at the end of that period.

Six. On the other hand, the rate of debt accumulation appears to have slowed significantly from an annual rate of increase of about 22 to 25 percent each year in the early- to mid-1970's to only 16 to 17 percent annually in the late 1970's. This lower rate has continued

into the early 1980's and we are projecting now a lower level of interest payments.

Within the trends I have been describing, two developments in particular need to be recognized. One is the dramatic shift to more LDC external financing from private sources during the decade. Private borrowing accounted for barely 50 percent of the outstanding total in 1973, but by 1980 amounted to roughly 60 percent of a total that was nearly four times as large. This trend has continued into the 1980's.

The other key development is an increasing concentration of debt, especially commercial bank borrowings, among a small group of LDC exporters of manufactures and/or oil. At present, 10 countries out of 143 LDC's account for more than 50 percent of total long-term LDC debt. While most of the developing countries that have current debt rescheduling problems are not in this small group of large borrowers from the private sector, a few of them are. Thus, it is legitimate to examine carefully what impact their problems might have on the health of the global financial system.

During the 1970's, what was foreseen as the major challenge to the financial system came from the expected recycling crisis of 1974–77. In the event, it proved ultimately to not have been a crisis but instead an important step forward in improving the flexibility and adaptability of the international banking system.

Admittedly, there were signs of strain and occasional disruptions—the REIT problems in the United States, the Franklin National Bank failure, the Herstatt Bank failure in Germany, the United Kingdom "fringe bank" problems and several others. But the system withstood these challenges. Regulators and other authorities took the necessary steps to control and contain these disturbances and many lessons were learned. Increased consultation among regulators was one result and it has strengthened during the intervening years. The ability of the existing institutions to cope with these problems gives evidence of considerable strength in the established procedures now in place.

Despite the psychological atmosphere of nervousness and instability created by major imbalances in the global payments system during the 1970's—unprecedented surpluses for the major oil exporters, and seemingly crushing deficits for many LDC's and some industrial countries—it is clear that those borrowing needs fed the phenomenal growth in private lending to many developing countries, adding importantly to the development of international banking activity. For the more advanced LDC's, these borrowings allowed them to make major strides in growth and diversification of their economies. At the same time, however, many countries failed to undertake the longer term internal policy adjustments essential for their economies to survive higher energy costs and periods of tighter global liquidity and economic stagnation.

The trends of the 1970's were associated with debt-servicing difficulties among a number of oil-importing developing countries. For those facing the extreme prospect of defaulting on their external debt, the established procedures of debt restructuring were available, in the so-called "Paris Club" for debt to official creditors and in the "London Club" for debt to private international banks. Through the decade of the 1970's, the frequency of Paris Club debt reschedulings amounted to about three each year. As pointed out in a recent study by the IMF,

these debt problems of the 1970's were primarily associated with what I would bluntly call domestic economic mismanagement, and most official debt reschedulings were negotiated in conjunction with undertakings on needed policy reform.

Let us now talk about the events of 1982. In the 1980's, trends in the global economy have compounded debt-servicing difficulties that are now affecting a larger group of countries. For oil exporting LDC's like Nigeria, the decline in both price and volume of exports has caused a deterioration of debt service ratios. For oil importing LDC's, the strong U.S. dollar has caused continued increases in oil import costs and to some extent increased balance of payments problems in a period of weak exports.

High and volatile interest rates, economic stagnation in industrial countries, a sharp drop in real commodity prices, and widespread inflation all help to explain a rash of debt reschedulings in 1981. But there are also developing countries with large debt burdens, for example in East Asia, which have faced the same problems without experiencing serious debt-servicing difficulties; in some cases, to be sure, severe domestic adjustment measures were required, and these were taken.

Thus the evidence continues to indicate that debt problems are principally symptoms of inappropriate domestic policies, overly ambitious development plans with large import requirements, faulty assumptions about inflation and commodity prices, and poorly structured debt maturities. Debt reschedulings, therefore, treat the symptoms, allowing more time—and, we hope, helping to establish the framework—for dealing with the causes of debt problems through needed policy reform. In this regard, a successful recent multilateral example is Turkey. In the future, when and if reschedulings become necessary, we hope for other similar examples. However, the fundamental ingredient remains a willingness on the part of national authorities and the capability to implement politically difficult economic policies.

In 1981 there was an unusual number of multilateral debt rescheduling negotiations with official creditors, eight of them. But this is not a good barometer of global financial stability. First of all, most of these were small countries that are not heavily dependent upon commercial bank lending and do not play a significant role in the international financial system. Second, most of these were African countries that are especially vulnerable to declines in commodity prices. Third, countries throughout the world that are experiencing balance-of-payments difficulties have a better appreciation of the lesson that adjustment cannot be postponed indefinitely and can be less costly when undertaken early.

The situation in 1982. Against the historical backdrop that I have sketched, we are now engaged in a careful and continuing review and monitoring of the current state of the world financial system. The recent IMF/World Bank annual meetings in Toronto contributed importantly to the evaluation process for us. We hope these discussions with your subcommittee will also.

It is important that we do not underestimate the nature of the problem, but we should also not be panicked into precipitous conclusions or actions. We are trying to facilitate realistic remedies for actual problems, financial and otherwise, in various parts of the world, in each case in ways appropriate to the circumstances.

So we are proceeding on what I might call an "analytical front" and also on an "operational front." Integrating our judgment and experience from both fronts so far, I would say that we do not regard the present situation as an actual or imminent crisis. But I would emphasize as well that there is no complacency in our present analysis and conclusions. We are concerned at the potential for irrational or irresponsible behavior, for superficial judgments, and for hasty, ill-conceived actions, and will do whatever we can to strengthen the system against them.

In 1982 the economic outlook has become especially acute for many developing countries. They have entered a third year of sharply higher, even though now declining, external payment deficits. They face continued export weaknesses in both their traditional and newer markets. This weakness now encompasses even the petroleum markets.

The fate of many LDC's is also interlinked with what is probably an unprecedented period of both disinflation and little or no real growth in industrial country economies. This is marked by growing pressures, so far largely resisted but even more insistent, for short-sighted, politically motivated protectionist commercial measures in those industrial economies.

The external position of the LDC's has also been aggravated by their growing debt. Such debt, which has continued to accumulate substantially from foreign private sector lenders and at wider spreads and at shorter maturities than before, will probably exceed $500 billion in total in 1982. Growth in the interest cost on their debt, a large proportion of which carries variable rates of interest, has lessened somewhat as a result of the recent decline in interest rates which has begun. But these interest costs are still substantial, exceeding $40 billion a year. Again, these developments were summarized in charts 1, 2, and 3.

But to put the U.S. anti-inflationary efforts into this perspective, each percentage point decline in the U.S. prime or LIBOR rate now represents $2 to $3 billion in annual interest payments saved by developing countries on variable rate debt.

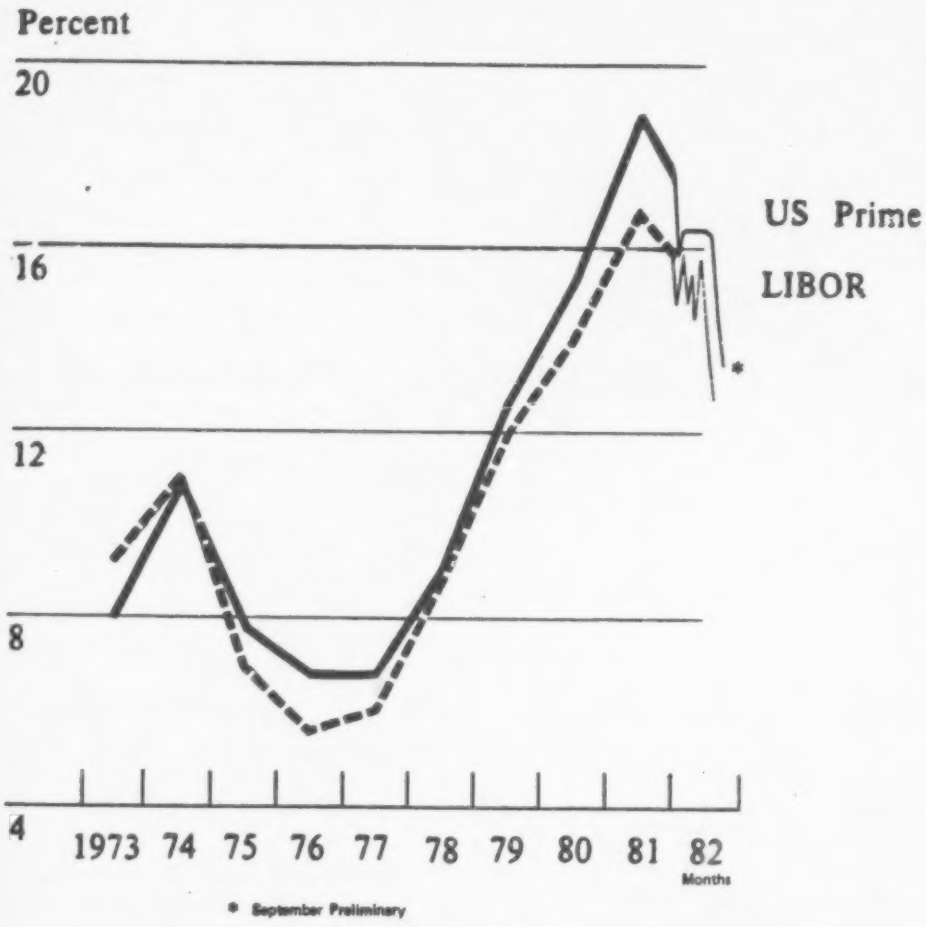
And I would aid parenthetically, Mr. Chairman, as you know, the total ODA expenditures of the United States are approximately $6 billion, so a very small decline in U.S. interest rates has the same salutory effect in terms of the payments burden.

Today our interest rates are still quite high, especially in real terms, as they have lagged behind the sharp reductions in U.S. inflation. [See chart 4.] Further declines are expected over the next two quarters.

Chart 4

TRENDS IN COMMERCIAL LENDING RATES

(Percent per Annun)



* September Preliminary

It is against this background that the impact of these factors is now reflected in a number of recent developments I would like to discuss.

One. For a handful of major LDC borrowers, significant market uncertainty has developed about their current creditworthiness. Conversely, some large debtor countries have managed to preserve their credibility as both creditworthy and politically responsible economic managers. It is no secret that many of the first group have been found in Latin America and many of the second in East and South Asia. But there are exceptions on each continent, and encouraging signs of recent progress. For example, just in the last month Argentina has agreed to mutual lifting of financial sanctions of the United Kingdom as well

as beginning a range of consultations with various external financing sources in t. e context of what appears to be serious domestic economic reform efforts. Similarly, Brazil has intensified an already stringent self-imposed economic and financial adjustment program.

Two. A substantial number of small developing-country borrowers that depend heavily on commodity exports and government aid to finance their external deficits appear stalemated in their efforts to keep their deficits at sustainable levels. Many of these are in Africa and Central America, where even with a substantial upswing in the state of the world economy, improvements in domestic economic management would still be needed. Zaire is an example which is often publicly cited.

Three. There is increasing caution generally among international commercial lenders to LDC's, although no one knows at this stage how substantial this trend has actuallly become. And there is increasing caution among depositors regarding those lenders, thereby enlarging the "maturity transformation risk," if you will, that the lenders must bear in their activities.

In this context, it is important to note that much of the present nervousness about international lending is not driven by increased caution on the part of sophisticated lenders—who understand country borrowers can experience cash flow problems during the short term but are creditworthy over the long term—but rather, uncertainty caused domestically by structural changes in our money markets where banks rely on noninternational depositors with short-term domestic perceptions, such as the money market fund industry.

Four. This increased maturity transformation risk is now being reflected in substantially higher spreads over LIBOR or prime and/or shorter maturities being offered to most LDC borrowers. By way of illustration—and ignoring the fees paid, which one should not for a complete analysis—it is instructive to contrast the Eurocurrency loan spread and maturity structure of some of those LDC borrowers over the past 2½ years.

For example, Brazil has managed to keep its average maturity at 8 years by accepting higher spreads, from less than 1½ percentage points in 1980 to more than 2 full points over LIBOR in 1981 and 1982. Presumably, they have paid higher front-end fees as well to keep the spread lower.

Argentina has held its average maturity to about 7 years by taking progressively higher spreads, again from 0.7 to 0.85 to nearly 1.1.

Mexico, however, saw its average maturity fluctuate from 6 years in 1980 to 8 years in 1981 and down to only 5 years so far in 1982, with spreads that were "low" but steadily increased from 0.6 to 0.75 to 1.1.

By contrast, Korea has average maturities of 8, 8, and 7 years in this period, at declining spreads of 0.8, 0.65, and less than 0.6 over LIBOR, perhaps reflecting increased market confidence in the Korean economic program.

Finally, India had maturities of 8, 9, and 10 years for this period at a spread consistently about one-half percentage point above LIBOR, suggesting that India could—and I would say "should"—be meeting substantially more of its borrowing needs from private sources than it has heretofore.

Five. In the aggregate, the concepts of "overlending" and "underlending" by the banking system are now increasingly under discussion in an effort to understand the degree to which market psychology and "herd instincts" carry individual lenders and the system as a whole beyond the bounds of prudence at one extreme—that is, overlending—or the other—underlending. There is no perfect quantitative empirical measure of what is "too much" or "too little." But commonsense would suggest that some means are needed for avoiding excesses in both directions, if we want to enhance stability in the financial system. In the present transition period, the need is for continuous adjustment on the part of developing nations and suitable commercial prudence on the part of creditors.

Six. Finally, an encourging trend in the current situation has been the increasing acceptance by more developing countries of the need for serious, even rather drastic, adjustment programs geared to the gravity of the circumstances. Korea, Brazil, Chile, and Turkey, for example, have all made important progress in this direction over the past 2 years, and we expect that Argentina and Mexico will demonstrate a similar resolve. Adjustments from an inflationary environment are excruciatingly difficult and politically costly. We in the United States are enduring this painful experience from our own self-imposed adjustment program. But economically sound policies represent the only durable approach to restoring national economies to non-inflationary sustainable economic growth.

Let me turn to the institutional framework for maintaining financial stability. As I said, it is our judgment that "the sky is not falling," nor is it likely to—despite the pundits who say it is. A major element in this assessment is the strength and the diversity of the international intitutional framework for dealing with both longer run economic adjustment and short-term liquidity problems. I would like to review with you some key parts of that framework.

First and foremost is the International Monetary Fund. The IMF has very substantial resources available for temporary balance-of-payments financing in support of its members' own efforts to implement the sound adjustment programs needed to restore their external positions to a sustainable basis. Although the figures can change rapidly with shifts in countries' balance-of-payments positions, we estimate the Fund currently holds on the order of about $30 to $35 billion in undisbursed usable resources and some $20 to $25 billion in resources that could be committed to new lending. Thus, we feel the Fund is reasonably well positioned at the moment to respond to financing demands in support of effective economic adjustment.

The Fund's leadership in promoting internationally responsible adjustment is critical to maintaining the sound, open trade, and financial system upon which all of us—developed and developing countries, creditors and debtors alike—depend. There is no stigma attached to implementing an IMF-supported adjustment program. Many developing countries have done so successfully. In recent years, two of the Versailles Economic Summit countries, the United Kingdom and Italy, have also used the IMF. There is no alternative to adjustment. But recourse to the IMF can help make the process more orderly and possibly less painful.

At the present time, discussions are moving ahead on a future increase on IMF quotas, its principal resources. It was agreed in Toronto to accelerate the quota review and to try to reach final decisions on the size and distribution of the quota increase by the spring Interim Committee meeting. We support an increase in quotas that would be adequate to enable the IMF to meet the temporary official balance-of-payments financing needs of its members in normal circumstances.

In addition, and as a complement to the quota increase, the United States has also raised the idea of a new permanent borrowing arrangement for the IMF. To eliminate any ambiguity or confusion, let me reiterate that this idea, if adopted, would be supplemental to the quota increase. Administered by the IMF, the borrowing arrangement would be on a contingency basis and could be drawn upon by the IMF to finance country use by the IMF in extraordinary circumstances. The general concept is to provide a standby line of credit to deal with extraordinary situations that might seriously threaten the international monetary system. This idea is presently being discussed further and will be considered by IMF members shortly in conjunction with the quota discussions.

Senator MATHIAS. I do not want to interrupt you, but I do think that is an extremely important statement, and one that I welcome.

Mr. MCNAMAR. Well, there had been some confusion as to whether this was a substitute or something that would be supplemental to the quotas.

Senator MATHIAS. I think it is very valuable. I wanted to have that cleared up.

Mr. MCNAMAR. That is why I wanted to say it twice.

Let me turn to the central bank arrangements. Another key element in the institutional framework is the relationship among major central banks, including a network of bilateral contingency "swap" lines. Among these central banks, there is an understanding that, when appropriate, they will take the classic "lender-of-last-resort" responsibility to support their commercial banks and work collectively to resolve short-term liquidity threats to international financial stability.

And in terms of meeting short-term liquidity needs, the Bank for International Settlements can play a very useful role, as was demonstrated recently in the case of Mexico.

The Multilateral Development Banks [MDB] are a third element in this international framework, and one which helps give a longer-term perspective in both the nature of resources provided and the objectives pursued. Overall MBD resources and lending programs have been growing substantially, and will continue to do so over the next several years, notwithstanding a shift of emphasis from concessional to hard lending for a number of more creditworthy borrowers, such as India. For some smaller and less advanced developing countries, concessional resources should and will be made available to them as an essential part of their external financing requirements. To a limited extent, IBRD structural adjustment loans, which provide fast-disbursing financial support, can be and have been used in conjunction with economic adjustment programs supported by the IMF.

In this regard, the Reagan administration is continuing its priority effort to fulfill internationally negotiated understandings to fund the Multilateral Development Banks. These are one of the most immediate

ways in which the United States can demonstrate its will and commitment to act in a responsible manner. And in this case, the cooperation of many elements of the Congress will be vital. As you know, we have had a number of discussions concerning the pending markup in the Senate Appropriations Subcommittee to insure that the administration's full request for $945 million for the fiscal year 1983 contribution to IDA is passed by the Appropriations Committee.

Let me next turn to the consultative groups. A fourth element is an array of aid consortia and consultative groups, led primarily by the World Bank, which serve to organize, rationalize, and to some extent increase the flow of official financial resources to developing countries under bilateral aid programs. The Turkey consortium organized through the OECD was particularly helpful. A number of additional consultative groups are now being discussed, particularly for African countries.

Let me turn to debt rescheduling. A fifth element in the institutional framework—admittedly providing only stopgap financial relief pending correction of more fundamental problems, but nevertheless important—are the Paris and London Club procedures for obtaining debt restructuring. Because rescheduling cannot be a substitute for internal economic adjustments, resort to debt restructuring should be minimized. However, we acknowledge that when accompanied by needed domestic economic reforms—usually as part of a stabilization package agreed with the IMF—debt relief can help a country to work through a difficult external financial situation.

Finally, we lay heavy stress on the role of bank supervisory and regulatory authorities in providing the assurance that prudence and propriety are being observed in banking and financial activities. Authorities in a number of countries—for example, in the Cooke Committee—are strengthening their surveillance of the worldwide activities of their banks so as to develop better early warning of any emerging problems, and to create a more stable psychological environment for international lending than presently exists.

More specifically, bank supervisors unilaterally and multilaterally have been implementing their referee function in the global lending process. Banks increasingly must report their activities to bank supervisors on a global consolidated basis. This is encouraging the banks to consider international lending in terms of risk to their consolidated earnings and capital base.

Furthermore, supervisors for some time have been urging banks to strengthen their international lending practices. For instance, the banking industry is now demanding better data and consultations from borrowers, analyzing and monitoring loans more closely, establishing more conservative repayment terms and conditionality on borrowers, and pricing loans more realistically. Finally, bank supervisors in all countries are demanding more adequate reserve provisions against international loan portfolios. I see these prudential disciplines as a very healthy reinforcement of the normal relationship between international borrowers and their banks.

Let me now turn to prospects for the future. As I have indicated at several points in these remarks, both our analysis and our experience suggest that the world is not on the verge of a major financial crisis. To modify the familiar metaphor of ambivalence, that the glass is

both half empty and half full, we see the glass as a little more than half full. Let me summarize why.

One. We conclude that the central requirement for long-term continued growth and stability in the world economy is the firm commitment of major countries and institutions to strong, effective adjustment measures. This commitment is growing, and it is bearing fruit, resulting from both our own progress in such areas as energy conservation, inflation control, and the level of interest rates, which directly benefit the global economy, and from the progress of others, such as the strong record of some developing countries which have recently accepted low or even negative growth rates in order to get their economies and financial situations under control and to lay the foundation for a sustained recovery.

Two. We conclude that, in objective terms, the degree of risk to the financial system and to world economic growth and stability has sometimes been overstated in the press and elsewhere. That is not to say that current market psychology and various perceptions are to be dismissed, because they can be self-fulfilling. What we must do is to determine the facts and examine past experience so as to minimize the danger of rash decisions and excessive market reactions.

Three. There is a strong multilateral framework of institutional support for the system, endowed with leadership, extensive experience, and the financial resources for dealing with a variety of situations. And this framework is being strengthened even as it faces new challenges.

Four. It is our judgment that there is a shared interest and common commitment, by governments and lenders of private financial institutions around the world, in maintaining the health of the systems in which they all have an important stake. An interdependent network of economic relationships—financial, commercial, and monetary—already binds them together, with powerful incentives for cooperation and significant penalties for irresponsible or autarchic actions. This concept of mutual self-interest is no idle abstraction in these circumstances. It is the basis for international stability.

At this point, the overriding question for all countries, developed and developing, is whether the national will and capability for following through on difficult adjustment measures can be sustained.

We think the answer is yes, but are not complacent. We acknowledge the international financial system is in a period of considerable strain. However, it should be able to cope with that strain through a combination of economic discipline on the part of borrowers, an appropriate degree of prudence on the part of private lenders, and careful monitoring and, where appropriate, provision of financing on the part of governments and central banks as well as the IMF. We will continue working closely with other countries to assure that the system is properly equipped to deal with potential problems, including the provision of official support if and where that becomes necessary. And, of course, finance ministries and treasuries of major countries are in continuing contact to consider and assess the situation as it evolves.

As the debt situation for developing countries, it seems likely that some additional cases of restructuring will be necessary, both to official and to private creditors. But it is also likely that the unusual confluence of economic trends that have been so devastating to many

LDCs will not persist. Firm adjustment policies, a nascent worldwide economic recovery, and the transition through disinflation to lower inflation and interest rates, combined with appropriate international support, should all help to mitigate this debt burden over the next few years.

Let me now turn to U.S. policy and our timetable for action. As the leading figure in the world economy, the United States has a unique role to play and diverse responsibilities and obligations both to itself and to the global financial community. While the next months will not be easy or devoid of sensational news, the United States will meet the challenge of financial leadership quietly, firmly, and as befits our responsibilities. I would like to summarize our basic policy in this regard and outline the actions we will be pursuing over the next several months.

First, let me sketch the broad policy.

One. We will maintain and promote open markets around the world. As you know, the major present vehicle for building and sustaining the necessary political will for free trade is the GATT ministerial session several weeks from now. We hope that that conference will launch a broad program of work and negotiation on improved trading relationships, and will devote ourselves wholeheartedly to that end. And at home, we will fight such shortsighted measures as the proposed "local-content" legislation in the House of Representatives. I mistakenly said that was the worst trade legislation in the last 25 years. I have been corrected by the distinguished chairman of that committee. It is the worst piece of legislation that has been introduced in the last 50 years.

Two. We will continue our vigorous pursuit of noninflationary economic growth accompanied by a continuing decline in interest rates. The benefits of our success in this endeavor will be worldwide and, we believe, catalytic to similar progress from the national economic policies of others.

Three. Let me reiterate our commitment to the international trade and financial agencies, particularly the IMF, during this period. We will foster a multilateral approach wherever possible. We are convinced that international cooperative efforts to deal with current problems are really the only sensible way to proceed. Thus, we support the efforts of the international trade and financial institutions and pledge to refrain from interference in the internal affairs and policies of other sovereign nations. Rather, the international consensus developed through the work of the multilateral agencies makes clear what actions are appropriate for individual countries as well as what constitutes inappropriate or irresponsible behavior.

Four Apart from the overall supervisory and regulatory requirements, we will not dictate to our financial institutions what they should or should not do in terms of who they do or do not lend to. We believe these decisions are best determined in response to signals from the marketplace. We will, therefore, work to insure that markets are operating with full, accurate information and a sense of stability in the policy environment and the regulatory regime.

Five. We, of course, will closely monitor the situation and maintain our contacts with other nations on a bilateral and multilateral basis and we will stand ready to assist in any way not inconsistent with these policies.

As to the timetable for the future actions, as I have indicated to begin with, we expect a resolution of the discussions on IMF quota increases and a possible special borrowing arrangement to be achieved sometime in the spring. We will consult closely with the Congress regarding necessary authorization and appropriations for U.S. participation in the arrangement. In the trade area, we look for a vigorous followup to the November GATT Ministerial, the nature of which will, of course, be shaped by the specific results of that meeting. But again, close consultations with the Congress will be necessary.

In all of this, we will need continued resolve and consistent policies to achieve success. And to that end, we look forward to working with the Congress to accomplish what must be done to fulfill our obligations as the world's financial leader.

Thank you, Mr. Chairman.

Senator MATHIAS. Thank you, Mr. Secretary. You have made a very useful and valuable contribution to this discussion. As I said when I interrupted you, I welcomed the clarification that you were able to offer, that the Treasury's proposal was supplemental to quota increases and not as a substitute for them.

You made it very clear that you feel there is a problem, but not a crisis. And I think you differentiated in your statement between the two situations.

But would you say that the problem has increased in seriousness in recent months? There was a view expressed by some people in the administration some time ago that certainly the larger developing nations with the larger debts had potentially great futures and do not worry about it, it was all going to work out all right. That view has somewhat dissipated, has it not?

Mr. MCNAMAR. Well, Mr. Chairman, I think a lot of people in the world—government officials, economic policy officials in developing countries, commercial bankers, investment bankers, academics—took the view, based on our experiences, our short-term experiences from 1973 through 1979, 1980, that we would continue to see double digit inflation year after year, with each successive year being somewhat higher than the last, that each successive year we would see higher and higher oil prices, with each year being higher than the last.

I think a lot of decisions were predicated on that basis, both in our own Government and in the private sector. I think that now there is a recognition on the part of all of those groups that that linear extrapolation of the past into the future is not to be, and that the world indeed has passed perhaps through one of those inflexion points in its economic history.

Senator MATHIAS. Well, I hope that you are a prophet in that respect.

Mr. MCNAMAR. I make no claims as a prophet, and I do not predict interest rates either.

Senator MATHIAS. Well, I can hope you are.

Mr. MCNAMAR. I am simply talking secular trends.

Senator MATHIAS. Right.

However you and I may hope that that is the way it develops, neither of us can predict with absolute accuracy, and for that reason people prepare contingency plans. Do you have in your mind some kind of contingency plans, a sort of worst case scenario to deal with the impact of a default by a major debtor on the international financial

system as a whole and on the stability of the American banking system? What would we do if one of these worst cases occurred?

Mr. McNAMAR. Well, from hanging around with Paul Volcker, Gordon Richardson, and Otto Poehl, they have taught me never to try to answer that question, even though I cannot take that mantle of ambiguity that a central banker would claim.

Senator MATHIAS. Well now, I did not ask you what you would do. I asked if you had a plan.

Mr. McNAMAR. We have several plans, yes. It would depend on what might happen, the appropriate actions you could take. I could give you some scenarios that would unfold over a period of 18 months or 2 years, that we would meet with a series of modest actions along the way. I can give you some other scenarios that could develop more quickly if some highly improbable set of hypothetical circumstances took place, and we in that case have some contingency plans as to what we would do on a more expeditious basis.

But the existing statutory authority of the Secretary of the Treasury and the Chairman of the Federal Reserve Board, which we have taken the prudence to go back and review, appear to be adequate for us to do anything that would be necessary.

Senator MATHIAS. Do you have any projections, or has the administration made any projections, as to the size of the LDC deficits that can be expected over the next few years? That would relate to your contingency thinking, it seems to me.

Mr. McNAMAR. We have made some of those projections. I am sorry I do not have them with me, Mr. Chairman. I would be delighted to submit them for the record if you would like.

Senator MATHIAS. We will hold the record open for 3 days and if you can get them down within that time I think it would be useful.

Mr. McNAMAR. Yes, sir.

[The material referred to follows:]

THE DEPUTY SECRETARY OF THE TREASURY,
Washington, D.C.

Hon. CHARLES McC. MATHIAS, Jr.,
Chairman, Subcommittee on International Economic Policy, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your request at the time of my September 27 testimony before the Subcommittee on International Economic Policy, I am providing the most recent Treasury forecast of the aggregate current account deficit (including official transfers) of the non-OPEC developing countries.

Current account balance: Non-OPEC developing countries

	Billions
1979	—$38
1980	—57
1981	—75
Projections:	
1982	—65
1983	—53

These forecasts were made by Treasury staff in August. (Current projections do not extend beyond 1983.) Some developments since these projections were made suggest that the aggregate LDC current account deficit may be diminishing somewhat more rapidly than we had projected. If the recent declines in interest rates continue, for example, there would be a larger decline in interest payments. Also, for some countries, reduced access to external financing is leading to more rapid adjustment efforts. While we cannot be very precise, it seems likely that the aggregate deficits in 1982 and 1983 might be several billion dollars smaller than our August projection.

You should be aware that the above figures are not entirely consistent with data provided in my testimony on the total debt burden of the developing countries, which came from IMF sources. This is because the IMF definition of the non-OPEC developing country group differs somewhat from that of Treasury, principally by the IMF's inclusion of the People's Republic of China, South Africa, and several of the Eastern and Southern European countries (Romania, Hungary, Yugoslavia, Portugal, Greece and Turkey).

Sincerely,

R. T. MCNAMAR.

Senator MATHIAS. But I assume that the mix of public-private lending that is going to be needed to finance these deficits is going to be somewhat in the current ratio, is it not?

Mr. MCNAMAR. I would anticipate that for the next several years you would be likely to see about that same ratio, with perhaps a supplement to the amount of involvement that the IMF has had. So let us make sure that we recognize that the IMF will be playing a role. It is no secret, for example, that Argentina has now approached the IMF and that a team is in Argentina right now, if my memory is correct. That was not on the horizon a year ago.

Senator MATHIAS. But that raises the question of the role of the commercial banks. Are they overextended, in your judgment?

Mr. MCNAMAR. No; I do not think the commercial banks are overextended. I think when a bank makes a loan it obviously must look at two things, perhaps three. One of course is the basic creditworthiness of the enterprise, whether it is a company or a country; two, it looks at the security that it might have for any loan that it would make; three, it looks at the cash flow that the enterprise, the company or the country, may have to service its debt obligations, both make interest payments and meet any maturing debt.

I think, because we are going through this period of transition that I described in my testimony, that a number of countries are experiencing a cash flow or, as they say, a liquidity problem in servicing those obligations. That does not affect their creditworthiness. It does not affect whatever security the banks might have. It only relates, in corporate terms, to their cash flow, their current quarter's cash flow or, in international terms, to their reserve and liquidity positions.

I think there are going to be some difficulties there. I think there will be difficulties there for the next months. We know the impact that a variety of factors have had on the world economy and that is what has exacerbated the cash flow problem of these countries.

Again, Mexico is a classic example of that, I think.

Senator MATHIAS. I suppose what either you or I think about the private banks being overextended is not as important as whether they think they are overextended and whether they retreat and retreat too fast.

Mr. MCNAMAR. I think it is interesting to make a bifurcation there, perhaps, between what I will call the major international banks—and you can pick what ever number you would like out of Japan, Germany, France, the United Kingdom, and other places, Switzerland certainly, and the United States—and a number of the smaller regional banks particularly in the United States, that have in the past purchased participations in loan syndicates.

I think that those banks, which are not perhaps as used to doing their own international analysis and simply do not want to have any

loans on their books that are troublesome, may be tending to be a little more reserved than some of the larger international banks are.

Particularly those banks, the regional banks in the United States, in the Southwest, that have seen the decline in drilling activity in the United States and decline in natural gas and oil activity, perhaps lessened some of their security on some of the loans that they thought they had. The collateral does not look quite as good as they thought it did. Because of that they may be pulling back on their exposure there, readjusting their reserves, and that would carry over into their willingness to buy into new syndicates for X, Y, or Z country that might be managed by an investment banker or a major Chicago bank or a New York bank or whatever.

So I think you may see more reluctance there. I think that is probably a normal reaction. I said the situation was somewhat self-correcting. They are going to demand larger fees and larger spreads, and I think you will see a widening of spreads.

You know, since we went to "spread" banking a few years ago—and it was introduced first in Europe and then in the United States, where you borrow at LIBOR plus X, and then in the United States, you have got dual pricing loans where you borrowed at prime or LIBOR plus X and so on, or prime minus X and LIBOR minus Y, or whatever—you have seen those spreads narrow on the international side.

And I would raise a question as to whether you have seen an adequate differentiation of the liquidity position, the security position, the security obtained in the loan and the creditworthiness of the countries. There has not been a great deal of discrimination or differentiation in those spreads, and I think that over the next 6 to 9 months you are likely to see that return. That would be a normal reaction.

Senator MATHIAS. Earlier today we had some conversation on the subject of coordination of the private sector banks' efforts, that perhaps there ought to be a greater degree of coordination. Do you have any views on this?

Let me explain that we talked about it in terms of perhaps Government advice—I do not think anyone was advocating Government direction—or coordination, to the extent that that was possible under the existing antitrust laws or under some liberalization of the antitrust laws.

Mr. MCNAMAR. I think our view is that those are private decisions that should be made by private organizations. The bank's money, the capital stock, comes from private investors, whether institutional or personal. Their deposits, of course, come from a wide variety of sources, some of which the U.S. Government has a role in insuring, some of which are simply purchased on the interbank market.

There has to be, I think, a Government framework within which those private decisions are made. I think that it is useful to share and exchange information. Sometimes the commercial banks learn something that we do not know. I expect more often they are interested in talking to us in the hopes of learning something they do not know.

We have tried to maintain what we thought was appropriate contact with those banks, and we have not leaned on them to do or not do anything.

Senator MATHIAS. In your statement you said that bank supervisors in all countries are demanding more adequate reserve provisions. Would you care to elaborate a little on that comment?

Mr. MCNAMAR. I may have said all countries, but I think I was really talking about the major countries. The Group of 30, the Cooke Committee chaired by Peter Cooke, the English bank supervisor, the group that meets at Ditchley Park periodically, have all had a number of discussions concerning the nature of sovereign risk lending, whether there was a satisfactory intellectual distinction between that and corporate lending, if you will, just as I went through it with you; and whether there should not be additional reserves developed.

I think that has been a useful discussion to go through, because they found, as is often the case, more similarities than dissimilarities in corporate and sovereign lending in terms of the nature of the cash flow. Essentially, banking is a cash flow business, and I think sometimes it is easy for either Government policymakers or even bank managers to lose sight of the fact that it is a cash flow business.

Sometimes bankers tend to focus a bit too much on short-term reported earnings and not enough on security and cash flow.

Senator MATHIAS. In resolving any perceived confusion that might have existed about the administration's policy on the quota question and whether other measures would be supplemental or substituted, I think you touched upon a perception that has been widespread, perhaps unfairly so, that the administration has not been very enthusiastic about the multilateral approach to these economic problems. That has been deduced from stretching out the IDA contribution or supporting a lower level of quota increases.

Would you want to comment generally about the philosophy of the administration at this point with respect to the international approach?

Mr. MCNAMAR. Well, again, let me reiterate that we think that in terms of the international financial situation and economic adjustment process, the multilateral approach to develop a consensus is the only appropriate way for the United States, in its leadership role, to work through the system, as opposed to working on a bilateral basis.

If I were to go back and look at a number of countries that we have given economic assistance to over the years and look at what adjustments they have or have not made, I would find that the disbursement of bilateral economic aid was generally accompanied by inadequate economic adjustment, as opposed to self-imposed and adequate economic adjustment.

The reason for that is very simple: That bilateral aid may be given for other political objectives, and that is a perfectly appropriate use of bilateral aid. I am not suggesting we should diminish it in any event, nor to let the Treasury Department take it over from the State Department. We do not suggest that either.

But in terms of affecting economic adjustment and promoting policies within individual countries that would be consistent with the international economic order, the multilateral consensus appears to us to be the appropriate way to do it.

Now, I think that there perhaps could be some criticism that this administration on occasion and other administrations on occasion have not adequately worked with the Congress to find out what we

could, in fact, deliver, and the United States has occasionally made commitments that it could not subsequently adequately deliver, whether because there was a change in administration, or Congress was unwilling to go along or for whatever reason.

We are trying to avoid that situation in this IMF quota increase. I have already talked with the chairman of the House Banking Subcommittee and the chairman of the Senate Appropriations Subcommittee. When I discussed it with the Banking Committee chairmen, since they were involved in markup, they said they would like to do it just as soon as they finish markup on the banking bill and get started on that. So we have approached them.

I am talking with you. We will be seeing Chairman Long in the House. We are trying to begin this process now, even though the earliest, the very earliest that we would be here for the quota increase, would be after the Interim Committee meeting next spring.

I think it is important to realize that, No. 1, we are obviously in favor of an increase in quotas for the IMF and we are interested in determining what that appropriate level might be. We have not specified a number at this point in time because we want: (a) to make sure that the IMF has appropriate resources to do whatever it has to do, but (b) that it does not have the resources that would tend to lead either the staff or the board to lessen their insistence on adjustment policies.

Any organization, private or public, domestic or international, has a tendency to spend what it is given. It is very hard, even in this administration, to find a lot of lapses in the appropriations at the end of the year. There is a certain—and I mean this in the best sense of the word—bureaucratic momentum that builds up. The same thing happens in capital expenditure budgets with some very large companies I know in the private sector. So there is no difference.

We do not want to provide funds that would give a bias for excessive expansion, and so we are trying to find that balance with other IMF members. And that is why we have not suggested a number. We are trying to discuss with them the appropriate numbers.

The same thing on the supplemental borrowing arrangements. We have not suggested a specific number on that because we wanted to introduce the idea in Toronto, subsequently get their reactions to it, find out what they thought might be appropriate conditions or terms, sizes, and so on. And we have been trying to play our role as a consensus builder, to pull out or draw out the other members, as opposed to suggesting or in any way thinking that we can impose our interest on those countries.

Senator MATHIAS. Well, at the outset let me say I agree with you. I think that the international institutions tend to be better disciplinarians than we can be on a bilateral basis, that that simply creates political problems for other governments and is not an acceptable way to improve the economic climate in countries around the world. And the international institutions can do a much more effective job, because they are international. And it just works better, and I think you are right, we have seen adjustments that could not have been obtained on a bilateral basis.

So that is one important reason that we need to support the international institutions.

Second, let me say that I will support your efforts to get the quota increased and to provide some other arrangement for a shorter term boost to the capacity of IMF. I would hope—I do not make this an absolute condition, but I would hope that the increased trade which will flow from this will flow largely through the Port of Baltimore. But we will take our chances on that.

Mr. McNAMAR. Senator Heinz has expressed his undying support for that increase going through Philadelphia.

Senator MATHIAS. Well, I am sure that the superior facilities in the Port of Baltimore will make it possible to get at least our share. I do not say more than our share. But as I said, that is not a condition of my support; that is just a pious hope.

Finally, just let me ask you this question. It was proposed this morning that the IMF might be permitted to have access to the private markets, private capital markets, as an alternative to recourse to governments. Do you have any views on that?

Mr. McNAMAR. That is an idea that is worth studying. That would produce cash in effect for the IMF to then spend. We would have the same concern there as we would about a quota increase that would produce additional resources over and above those that are needed for continued adjustment.

And to the extent that the IMF were to go into the credit markets and compete, presumably in the Eurodollar market, they would be operating somewhat similar to the way in which the BIS operates, with in effect the guarantee of their members being subordinated to their guarantee and therefore able to borrow at a reasonable rate.

I think that it is an idea that ought to be considered along with the borrowing arrangement that we have in mind. Again, I would not like to see that as a substitute for finding an appropriate quota level. Again, I would have the same reservations that someone not propose a borrowing arrangement instead of a quota increase. I think that it ought to be analyzed in terms of an additional tool of the facility.

And again, if I might use a private sector analogy, just as a company might be able to go out with common stock, preferred stock, short-term debt, commerical paper, lines of credit, long-term bonds, convertible preferred, puts, calls, everything else, you have a variety of mechanisms available. And we think that it is quite appropriate, as the world changes from the days of Bretton Woods, that the IMF consider and look at alternative proposals like that.

Senator MATHIAS. We thank you very much for coming here today.

Mr. McNAMAR. Thank you very much, Mr. Chairman.

Senator MATHIAS. If you will provide that additional information for the record, we will appreciate it.

Mr. McNAMAR. Thank you, Mr. Chairman.

Senator MATHIAS. This subcommittee is adjourned.

[Whereupon, at 12:53 p.m., the subcommittee adjourned, subject to call of the Chair.]

APPENDIX

Prepared Statement of John A. Mathieson [1]

Developing-country debt and international financial strains

The level and growth of the accumulated external debt of developing countries, when coupled with prevailing economic conditions, pose a major challenge to the viability of the international financial system. While the system remains strong and does not face imminent collapse, its ability to carry out the important function of aggregating and distributing pools of international capital and credit is increasingly being called into question.

In isolation, the problem of developing-country debt is serious but manageable. However, this problem is compounded by the fact that the debt situation is only one corner of the complex web of economic and financial forces that make up the international economy, and many if not all of these forces are now under strain. In addition, the high degree of interdependence among financial transactions, which in general periods of growth add strength and robustness to the system, have a tendency to make the system more fragile and vulnerable during periods of sustained economic contraction.

The rise in developing country debt

Developing-country debt has risen at an average annual rate of 23 percent over the past decade, from $68 billion in 1971 to about $540 billion in 1981. Accumulating debt is not new to the developing countries, since it is a natural phenomenon experienced in the growth process. Countries at early stages of development borrow capital and attract investment inflows, partly to pay for needed imports not covered by export earnings, and partly to finance development.

The United States itself went through such a period. During most of the 19th century, the United States was a net importer of capital, much of which was used to finance the construction of America's economic infrastructure. These capital inflows also offset deficits experienced in the trade and current accounts.

On these grounds one might reasonably conclude that the growth of developing-country debt is transitory and therefore not a matter of undue concern. However, during their early stages of development the industrialized countries benefitted from stable or even declining prices for many essential products. For example, for the United States, the cost of food and fuel in real terms in 1900 was about one-third of the cost prevailing in 1811, and these costs did not return to the 1811 levels until the 1940's and 1950's. The industrialized nations also had much longer periods to develop the infrastructure and productive capacity necessary to settle foreign indebtedness.

Most developing countries have not been so lucky. Throughout the latter part of the 1970's and early 1980's, the oil-importing developing countries took on debt not only for standard developmental purposes and to cover normal trade deficits, but also to finance large and growing bills for food and fuel. The total current account deficit of the non-oil developing countries rose from $39 billion in 1978 to $99 billion in 1981, with a projected $97 billion deficit in 1982. The 1980 deficit amounted to nearly 5 percent of the oil-importing developing countries' aggregate GNP, compared to a share of only slightly over 1 percent in 1973.

In addition, the economies of many developing countries have been mismanaged as a result of inefficient subsidy programs, inappropriate infrastructure investments, and overly-ambitious development programs. Finally, at least a portion of the blame for the current debt situation lies with the private banks themselves, some of which imprudently pushed funds into countries without adequately ex-

[1] International Economist, SRI International, Arlington, Va. The views expressed here are those of the author, and do not necessarily represent those of SRI International, its directors, officers, or staff.

amining future repayment capabilities. These deficits and rising debt exert a significant drag on the growth prospects of the developing countries, since they must implement "adjustment" policies, in this case a euphemism for decreasing consumption in order to reduce deficits and service debts. A corollary effect of adjustment efforts, which no one suggests are unwarranted, is a reduction in demand for imports produced in the industrial countries. Therefore, the debt problem affects real economic activity in both developing and developed countries.

The deteriorating debt situation

The accumulation of developing-country deficits and debt was managed successfully throughout the 1970's, primarily through the financial intermediation of private banks (the "recycling" process), but with the assistance of the International Monetary Fund (IMF) and the international development banks. In recent years, however, the intermediation process has been affected by a convergence of factors adverse to debtor countries.

While the terms associated with debt (the maturity and interest premium or spread on borrowings) varies significantly among developing countries, there has been a general deterioration. In Mexico, for example, the average loan spread has risen from 0.6 percent in 1980 to over 1 percent in 1982. The average maturity of Brazil's Eurocurrency credits fell from 12 years in 1979 to about 8 years in 1981.

Given the widespread adoption of variable interest rates, the interest rate risk previously held by lenders has been shifted to borrowers. A major portion of developing countries' borrowing is in the form of variable-rate debt, and Eurocurrency interest rates have until recent months remained at historically high levels.

Real rates of interest (adjusted for inflation) have increased from normal levels of 2–3 percent to over 10 percent, hence, raising real interest costs as debt is rolled over.

These financial variables affecting developing-country debt have eased somewhat in recent months as interest rates have gradually declined. However, the basic problem of accumulated debt remains, and will continue to grow in the foreseeable future. The major task of financial intermediation lies ahead, and this process has encountered its own set of rising problems.

Strains in financial markets

Efforts to arrange adequate and prudent financing of developing country debt do not proceed in a vacuum, but rather both affect and are affected by prevailing conditions in international capital and credit markets. These markets are experiencing increasing strains.

As part of its economic recovery plan, the U.S. Administration has relied heavily on a tight monetary stance. When combined with heavy borrowing requirements to cover government deficits, this policy has obviously led to rising interest rates, which in turn lifts the cost of borrowing and/or limits the availability of funds. The United States has experienced an extraordinary level of net private capital inflows, some $69 billion in 1981. These inflows are attracted by relatively higher yields, the high value of the U.S. dollar, and the security of investments relative to those in less stable ecoromies. Some $30 billion of the net capital inflows into the United States originated in Latin America.

To avoid large scale capital outflows, most of the major industrial countries have been forced to follow the U.S. suit and raise their own interest rates. While most rates have softened since their peaks of mid-1981, they have contributed to generally tight market conditions.

Due to protracted economic stagnation in both Europe and the United States, most industrial countries have witnessed an abnormally high level of bankruptcies or near-bankruptcies, including those of large firms in both the financial and non-financial sector. The reorganization of these firms or the settlement of their liabilities has placed an additional call on available financial assets.

Conditions of excess supply in the international oil market have resulted in a softening of oil prices, to the benefit of net oil importers in both developed and developing regions. However, this has also contributed to a drying up of OPEC surplus funds, upon which intermediating banks (and ultimately borrowers) have come to rely for deposits. The aggregate current account balance of OPEC members is expected to decline from a surplus of some $60 billion in 1981 to about a balanced or even a deficit position in 1982. A growing number of oil exporting countries (including non-OPEC and some OPEC members) have themselves entered the Eurocurrency market as borrowers.

In the past, IMF lending and private bank lending tended to work in tandem and were mutually reinforcing. In recent years, the more advanced developing countries have avoided borrowing from the IMF to preclude the imposition of IMF conditions, and instead have depended on private sector borrowings. The IMF, in turn, has shifted its lending portfolio away from the industrial countries and toward many of the less creditworthy developing countries. Recent IMF decisions indicate that additional credit to a number of these borrowers will be less forthcoming until they are more successful in meeting established conditions, and private banks are even more wary of extending more loans to these borrowers.

Finally, the list of countries currently or potentially in arrears in meeting their debt servicing obligations is growing. The number of official debt rescheduling has grown. To be sure, most of these reschedulings have involved relatively small nations, primarily in Africa. However, recent developments involving such large borrowing nations as Turkey, Poland, Mexico, and Argentina indicate that the magnitude of normal loan rollovers and more serious debt reschedulings (perhaps involving interest as well as principal payments) is likely to expand rapidly.

All of these factors combine to make the process of solving or at least managing the problem of developing-country debt more difficult. What has developed is an emerging system of credit rationing, both between various groups of countries according to their relative degree of perceived creditworthiness, and, more seriously, between various groups of banks according to perceptions of the relative security of their loan portfolios. The process of interest rate "tiering" among banks in the interbank market, which is considered a warning signal of growing stress, is already well under way.

Debt-servicing capacity

The developments and factors noted above are primarily financial in nature, dealing with trends in liquidity and cash flow. Like individual's, sovereign nations can experience difficulties in cash flow without necessarily impairing their long-term capacity to earn income and service debt. The growth potential for most of the developing countries is strong over the long run, as these nations utilize their comparative advantages and introduce greater efficiencies into their economies. However, this potential has at least in the current period been retarded by several developments in the international economy, with obvious implications for near-term debt servicing capacity.

For the first time since 1958, the value of world trade declined in 1981, by one percent. The volume of world trade was also stagnant. A similar performance is anticipated for 1982. Over the course of the 1970's, the value of world trade rose about 20 percent annually, and increases in developing-country exports served as a major basis for establishing creditworthiness and securing borrowings. Due to worldwide stagnation, developing-country exporters have encountered stagnant markets for their goods.

Declines in the volume and price of petroleum exports has particularly hurt the "high absorber" oil producers such as Mexico, Nigeria, and Indonesia. These and other nations have depended heavily on oil revenues to finance domestic consumption and investment, and recently have been forced to take extraordinary measures to reduce levels of imports, much of which came from industrial countries.

Many developing countries, particularly the less advanced, are highly dependent on earnings from commodity exports. The IMF's composite commodity price index has fallen about 33 percent from its peak in 1980 to April of this year. Certain key commodities have fallen even further in price: copper by 44 percent, cotton by 34 percent, and rubber by as much as 62 percent.

In order to increase and diversify exports, a number of the more advanced developing countries have actively sought export opportunities in areas other than the Western industrial countries, and in some cases these efforts have included attractive forms of credit. While this diversification strategy may be appropriate, it has led to some unforeseen side effects. Brazil, for example, is reported to have extended significant amounts of export credit to Poland and a number of African nations, all of which have debt repayment problems of their own, hence, potentially recycling these problems to Brazil.

Most of these economic problems affecting the developing countries' capacity to service debt repayments (and hopefully retain adequate levels of consumption) are cyclical in nature, and will be alleviated as economic growth worldwide is restored. However, the convergence of these developments indicate that the major financing task lies ahead.

Conclusions

The debt problems facing the development countries have been created by a combination of their own lack of development, economic mismanagement in some cases, and circumstances beyond their control. The situation has been exacerbated by adverse trends in international financial markets which are both real and psychological.

It is currently fashionable to list or rank countries which are to be "next" in experiencing serious liquidity difficulties. While such an exercise is of course important to private banks which must determine lending limits and the optimal distribution of their loan portfolios, it tends to distract the policymaking community from engaging in serious discussions on improving the system for dealing with near-term financial crises and on laying the groundwork necessary for long-term solutions.

So long as the international financial system remains smoothly functioning, it is proper and appropriate for individual actors to carry on their own business, and for each loan and each country's creditworthiness to be judged on its own merits. However, when the system itself encounters a growing level of uncertainty and vulnerability, the liquidity problems encountered by one nation can have an adverse impact on other, more creditworthy nations through a "spillover effect."

The developing-country debtors must bear the bulk of the adjustment burden themselves, by reducing consumption levels and reallocating resources into productive economic activities. These politically-difficult efforts will have to be supported by a continued level of access to credit from both private and official sources.

Sustaining lines of credit will require higher levels of coordination on the part of private financial institutions, if only to preclude unwarranted "runs" against particular countries or their creditors. Private banks are in the process of developing common country reviews, but only gradually given the competitive nature of the market and certain anti-trust considerations. A larger coordinating role could clearly be undertaken by the IMF, the World Bank, or some joint committee. In this process, the financial community as a whole should reach a greater consensus on a working definition of "prudent" lending practices that assure adequate but not excessive financing.

Traditional forms of financing could productively be supplemented by innovative instruments such as "co-financing," which mix private and official capital. New sources of international capital, such as insurance company holdings and pension funds, could also be explored and tapped for productive investments, and possibilities for new forms of bilateral or multilateral guarantees could be examined.

These and other initiatives can be undertaken to provide "bridging finance" through the current period. In due course, however, the long term growth prospects of the debtor countries will have to be enhanced to assure the eventual repayment of accumulated debts, even if these are replaced by new debts of some form. Improving the growth prospects of the developing countries will in turn require coordinated efforts to keep the international trade and financial markets as open and smoothly functioning as possible.